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STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET-DOMINANT PRODUCTS	Docket No. R2017-3

COMMENTS OF THE UNITED STATES POSTAL SERVICE

By its attorneys:

Kevin A. Calamoneri
Deputy General Counsel, Headquarters

R. Andrew German
Managing Counsel, Legal Strategy

Keith E. Weidner
Chief Counsel, Legal Policy & Legislative
Advice

Abigail K. Healy
Jacob D. Howley

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
Phone: (202) 268-2000
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I. INTRODUCTION AND SUMMARY OF COMMENTS

On December 20, 2016, the Commission issued Order No. 3673, establishing this docket to conduct the 10-year review of the market-dominant regulatory system required by 39 U.S.C. § 3622(d)(3). That provision states as follows:

> Ten years after the date of enactment of the Postal Accountability and Enhancement Act [PAEA] and as appropriate thereafter, the Commission shall review the system for regulating rates and classes for market-dominant products established under this section to determine if the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c). If the Commission determines, after notice and opportunity for public comment, that the system is not achieving the objectives in subsection (b), taking into account the factors in subsection (c), the Commission may, by regulation, make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives.

This review therefore covers "the system for regulating rates and classes for market-dominant products established under [Section 3622]," and contemplates a two-step process. First, the Commission must review whether the existing system is achieving the statutory objectives, taking into account the statutory factors. Second, if the Commission determines that the existing system is not achieving the objectives, taking into account the factors, the Commission has the responsibility to modify the system or adopt an alternative system as necessary to achieve the objectives.

In Order No. 3673, the Commission set forth its preliminary views regarding the scope of the review, the meaning of the objectives, and the ways in which it might measure whether the objectives are being achieved. The Commission also phrased four questions to guide the comments filed by parties. Specifically, the Commission requested comments regarding the proposed framework of the review, including its preliminary conclusions regarding the scope of the review and the objectives (Questions 1 and 2); whether the current system is achieving the objectives, taking into account the factors (Question 3); and if the system is not achieving the objectives, taking into account the factors, what modifications or alternative system should be established in order to achieve the objectives (Question 4).

A. Overview of Postal Service Filing

In response to Order No. 3673, the Postal Service files these comments along with a number of appendices. The Commission's first two questions are addressed in Sections II and III of these comments, the third question is addressed in Section IV, and the fourth question is addressed in Section VI. Section V compares and contrasts the current system with the regulatory systems employed in the postal sectors of other countries, which is relevant to answering both the third and fourth questions. The appendices are as follows:

- Appendix A is a prior analysis that the Postal Service submitted to the Commission in FY2015 regarding the Commission's authority under Section 3622(d)(3), in response to a white paper from various mailer groups arguing that the Commission lacks the authority to replace the current price cap.
- Appendix B is a report prepared by Evercore, which analyzes how the term "financial stability" should be defined and measured in the context of the Postal Service.
- Appendix C is a report prepared by Alvarez and Marsal (A&M), which conducted a comprehensive assessment of the Postal Service's operations. The A&M report discusses the scope and magnitude of the cost savings opportunities that the Postal Service has under existing service levels.

- Appendix D is a report by Christensen Associates that explains the calculation of Total Factor Productivity (TFP), compares TFP to other potential ways of measuring efficiency gains, and discusses how TFP results should be assessed.
- Appendix E is a report by Christensen Associates that constitutes its assessment of whether the current system is achieving the objectives (taking into account the factors), and analyzes potential means of constructing an alternative system to achieve the objectives.
- Appendix F is a detailed discussion of the regulatory systems used in Canada, Australia, France, Germany, and the United Kingdom.
- Appendix G contains two charts projecting the Postal Service's losses and liquidity over ten years, assuming the continuation of the current system.[1]

B. Summary of Filing

Section II discusses the scope and purpose of this review. The plain language and legislative history of Section 3622(d)(3) clearly demonstrate that Congress inserted it into the PAEA to give the Commission, beginning 10 years after enactment, both the authority and the responsibility to ensure that the market-dominant regulatory system is achieving the objectives that Congress intended the system to effectuate. While Congress considered imposing a permanent price cap based on the Consumer Price Index for All Urban Consumers (CPI-U or "CPI"), it ultimately determined to mandate such a system for only the first 10 years of the PAEA, in recognition that as circumstances evolved a different regulatory system could become necessary to

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[1] Appendices C and G are being filed non-publicly, as discussed in the application for non-public treatment attached to these comments.

achieve the objectives. Arguments that the current price cap system is sacrosanct under the statute are thus completely unfounded. Equally baseless are arguments that this straightforward grant of regulatory authority to the Commission presents constitutional concerns: the authority Congress has given to the Commission under Section 3622(d)(3) is no different from that exercised by other regulatory agencies, which are also empowered to design rate regulation systems to achieve statutory policies.

The Commission is therefore correct in concluding that all provisions of Section 3622(d), including the CPI-U price cap and the exigency clause, are within the scope of this review. While the achievement of the objectives has heretofore been subordinated to the principles of the current price cap system, the Commission's task in this proceeding is to now review whether the current system is achieving the objectives (taking into account the factors), and, if not, to design a system that does achieve the objectives. Furthermore, if the Commission concludes that the current system is not achieving the objectives, and hence must be replaced, Congress has broadly authorized it to design whatever "alternative" regulatory system it considers necessary to achieve the objectives. The plain language and legislative history of the PAEA demonstrate that this "alternative" system does not have to be a price cap system.

On the other hand, the Commission should reconsider its position that this review encompasses the standards set forth in Section 3622(e) that workshare discounts not exceed 100 percent of their avoided costs. As the Commission has recognized in Order No. 3673, the scope of Section 3622(d)(3) does not extend to all provisions that regulate market-dominant rates and classes, such as Section 3626. When the language of Section 3622(e), the structure of Section 3622 as a whole, and the legislative history are examined, it is evident that while the workshare discount provision regulates market-dominant rates and classes in a generic sense, it is not within the scope of the "system" that is to be reviewed under Section 3622(d)(3).

Section III discusses the objectives and factors. The objectives, which the system must be "designed to achieve," set forth a variety of policies that are to be applied "in conjunction" with each other, meaning they must all be appropriately accommodated and balanced within the regulatory system. There is not an appropriate balance if the system is failing to achieve one or more objectives. The Commission has generally set forth reasonable definitions of the various objectives and how their achievement should be measured, although a number of clarifications and refinements regarding these matters are appropriate.

At their broadest level, the objectives require the market-dominant regulatory system to give the Postal Service the opportunity to generate adequate revenues from its market-dominant products so that, in combination with the revenues generated from competitive products, it can achieve its universal service mission and fulfill its other statutory obligations in a financially stable manner, while exercising efficient management. Congress intended that the PAEA set forth a regulatory structure that enables the Postal Service to sustainably provide universal service in a marketplace characterized by increasing electronic diversion, which has fundamentally changed how society uses the mail. To accomplish this, it replaced the breakeven standard and the rate case process of the prior ratemaking regime under the Postal Reorganization Act (PRA) with a system predicated on ensuring the Postal Service's ability to maintain “financial stability” through management that has a duty to “to reduce costs and increase efficiency.”

In balancing these objectives, there is no rational basis to interpret the PAEA as indicating any intent on the part of Congress to preclude the Postal Service from maintaining financial stability while it is being efficiently managed within the constraints and requirements that Congress has established. Two objectives (Objective 5 and Objective 8) directly require that the market-dominant regulatory system enable the Postal Service to be financially stable, while the achievement of a number of other objectives (including Objective 3) is dependent on the Postal Service’s ability to achieve and maintain financial stability. Considering the fundamental policy that the Postal Service operate in a self-sufficient manner, financial stability necessarily means the Postal Service’s ability to sustainably cover its costs over the long-term. In this regard, the Commission appropriately recognizes that in considering the Postal Service’s ability to reduce costs and increase efficiency, it is necessary to recognize the “statutory constraints” under which the Postal Service operates: the ratemaking system under Section 3622 exists within a broader statutory structure which ultimately dictates significant elements of Postal Service costs. This is true even if the Postal Service, Commission, or postal stakeholders would prefer that Congress change postal policy to reduce certain of those costs.

The Postal Service’s “basic function” is to provide universal postal services in a manner that serves the needs of the American people. Indeed, ensuring that the Postal Service can maintain “high-quality service standards” is one of the objectives that the system must achieve. Achieving this statutory universal service mission in a financially stable manner requires that the market-dominant regulatory system enable the Postal Service to have the resources necessary to make capital investments to sustain and modernize its infrastructure, and to otherwise have an appropriate level of resources to maintain efficient operations and withstand adverse marketplace developments.

Furthermore, the provision of high-quality universal postal services to an ever-expanding delivery network is a labor-intensive activity: the Postal Service must maintain adequate complement to provide service across that network, but has limited control over its labor costs. First, the Postal Service is required to participate in various federal benefits programs, and the payment obligations arising from these programs are a very substantial portion of Postal Service expenditures. Second, wages and other terms and conditions of employment are generally determined through a collective bargaining process that, in cases of impasse, culminates in binding interest arbitration. In assessing the market-dominant regulatory system's achievement of the objectives, the Commission cannot disregard these costs, or seek to influence or dictate the outcome of the collective bargaining process.

At a narrower level, the objectives also set forth policies that the system must achieve regarding the specific ratemaking process for market-dominant products, both in terms of the process used to set rates and the relationships between those rates. By eliminating the breakeven regime and the rate case procedures, Congress wanted to give the Postal Service greater flexibility, both in terms of its overall ability to use rate increases as a tool for a business-like financial policy, and in terms of its ability to determine the specifics of rate design in order to pursue its business goals and adapt to a changing marketplace. The Commission's role is to ensure that in the exercise of this flexibility, the Postal Service adheres to legal requirements and provides mailers with predictability and stability in rates, while also ensuring that mailers and other postal stakeholders are provided with appropriate transparency regarding the Postal Service's rates, costs, and other relevant information.

Section IV discusses whether the current price cap system, characterized by a CPI-U price cap applied at the class level and a narrow exigency exception to the cap, is achieving the objectives (taking into account the factors). The Commission cannot rationally conclude that the current system is even coming close to achieving each of the objectives. In particular, it is abundantly clear that the current system has not enabled the Postal Service to maintain financial stability or set rates that are "just and reasonable." The Postal Service has experienced 10 straight years of net losses, totaling $62.4 billion. As a result of those losses, the Postal Service has been at its statutory borrowing limit since 2012. It has only been able to maintain a modest level of liquidity to continue operations by defaulting on $33.9 billion of statutory obligations (the prefunding payments for retiree health benefits) and deferring needed capital investments, along with implementing the Commission-approved exigent surcharge that has now expired.

These losses have occurred even though aggressive management over the past decade has substantially reduced the Postal Service's costs and increased its efficiency, in accordance with its duty under the PAEA to continuously pursue cost reductions and efficiency gains. To account for declining volume, the Postal Service has rationalized its retail, processing, and delivery networks and substantially reduced employee complement and work-hours. Substantial cost savings have also been generated through the collective bargaining process, such as through the increase in the allowed number of non-career employees and the establishment of a two-tier wage schedule for career employees.

Despite these efforts, the Postal Service is therefore in a highly precarious financial position, with no realistic prospect of achieving financial stability so long as the current system remains in place. Indeed, a continuation of the price cap would mean that, moving forward, the Postal Service would continue to have net losses each year. The Postal Service would only be able to maintain liquidity to continue operations by continuing to default on a number of statutory obligations to fund its post-retirement benefit liabilities, meaning the Postal Service would not be able to address over time the extensive gap between its assets and liabilities, which could ultimately require that taxpayers finance those benefits. Ultimately, the Postal Service's available liquidity would be inadequate to ensure its continued ability to provide prompt, reliable, and efficient universal postal services. In particular, the Postal Service would continue to be highly vulnerable to potential adverse changes in market conditions, as it would continue to have a maximum level of debt, and available cash on hand would be wholly insufficient for an organization of the Postal Service's size. This financial position could also continue to negatively affect the Postal Service's ability to make capital investments, which the Commission has recognized are essential moving forward.

The reasons for the Postal Service's financial position are well-known to the Commission: the precipitous decline in mail volume since the PAEA was enacted, coupled with an inflexible cost structure, has made it impossible for the Postal Service to cover all of its costs while being subject to a price cap that requires that real market-dominant rates stay constant except under highly restrictive circumstances.

First, providing universal service requires an extensive network, which generates a large amount of institutional costs. Because the Postal Service does not impose a fixed charge to customers to access the network, it is reliant on mail volume to ensure that its costs are covered. The Postal Service is therefore highly vulnerable to mail volume declines: declining mail volume leads to declining economies of scale and density, which result in higher unit costs even before inflation of input costs is taken into account. Moreover, these effects are exacerbated by the fact that the Postal Service's network is continually expanding due to the rising number of delivery points.

Second, total volume has declined precipitously over the past decade, both in terms of the absolute amount of mail moving through the system (a 28 percent decline from FY2006) and in terms of First-Class Mail (a 36 percent decline from FY2006), which provides the highest contribution to covering the Postal Service's institutional costs. Moreover, whereas Marketing Mail (then called Standard Mail) was growing prior to the PAEA, it has also declined significantly since then (a 21 percent decline from FY2006). The Commission has noted that this level shift in First-Class Mail and Marketing Mail constitutes a "new normal," which is fundamentally distinct from the situation that existed when the PAEA was enacted. While the challenges that declining First-Class Mail volume presented to the Postal Service's financial sustainability were well known when the PAEA was enacted, the severity and scope of the volume declines that actually occurred after enactment were completely unanticipated.

These volume declines and changes in the mail mix, coupled with rising delivery points, have resulted in a significant decline in contribution-weighted volume per delivery point in the last decade. The price cap has, in turn, vitiated the Postal Service's financial stability. While unit cost has increased by well more than inflation due to the declining economies of scale and density, the price cap limits increases in unit revenue to the change in consumer inflation, without considering how unit cost is increasing due to volume changes or the fact that many Postal Service costs increase at rates above consumer inflation.

The Postal Service has, and will continue to, adhere to its duty to aggressively pursue cost reductions and efficiency gains in order to respond to the challenges of declining volume. However, in order to sustainably cover its costs, the Postal Service must pursue a comprehensive strategy that combines initiatives to reduce its costs and increase its efficiency and rate increases to increase the unit contribution provided by the volume that remains in the network. The current price cap prevents the Postal Service from using rate increases for market-dominant products as one tool to address the financial consequences of declining volume. Moreover, while the Postal Service has been successful in growing revenues and contribution on the competitive side, its ability to do so is inherently constrained by marketplace conditions, and the contribution generated from those products simply cannot replace the contribution that has been, and will continue to be, lost from declining market-dominant volumes.

The Commission must recognize that such an imbalanced structure is simply not workable, considering the Postal Service's need to maintain adequate levels of service and fulfill its other statutory obligations, and the constraints imposed on its ability to reduce costs. In particular, the Commission should reject arguments that the current system could work if only the Postal Service were more efficient. As the A&M Report validates, while the Postal Service has been aggressively in pursuing opportunities to achieve cost reductions and efficiency gains, and will continue to do so, the opportunities for further cost savings come nowhere close to allowing the Postal Service to maintain financial stability under the current system. Therefore, second-guessing management decisions or asserting that the Postal Service simply must be more efficient are not rational bases to conclude that the current system is capable of achieving the objectives. Furthermore, the Commission should not conclude that the current system would be capable of achieving the objectives if service levels were changed: not only is the current financial gap too large to be filled by reducing service, but existing service levels are either directly established by Congress, or are reasonably determined by the Postal Service to be currently consistent with the qualitative universal service standards established by Congress.

To be sure, one way in which to also address the financial consequences of the volume declines that have occurred over the past decade, and that will continue into the foreseeable future, is through statutory change, and the Postal Service has been seeking the enactment of postal reform legislation (H.R. 756) that would, among other things, address certain of the Postal Service's post-retirement benefits costs. However, the existence of this pending legislation does not impact the Commission's conduct of this review. As an initial matter, the Commission must, in applying the objectives, consider the statute as it is, not as it might be if postal reform legislation were enacted into law. Ultimately, if legislation is enacted either during this proceeding, or after this proceeding, the Commission can assess its impact then. In any event, even if legislation were to be enacted, the current system would continue to fail to achieve the objectives, and the Postal Service's proposed alternative system would still be the best means of achieving the objectives moving forward. Indeed, the optimal way in which to address the Postal Service's current financial condition would be through a combination of regulatory and legislative reform (along with continued aggressive efforts by the Postal Service to cut costs, increase efficiency, and grow revenue); enactment of postal reform legislation standing alone is not sufficient.

Section V discusses the regulatory systems governing comparable posts, which like the Postal Service face the same fundamental challenges of declining demand and hence declining economies of scale and density. These systems seek to effectuate the same basic principles as the objectives governing this review: ensuring the efficient and financially sustainable provision of quality universal postal services in a fundamentally challenging marketplace. Examining these other systems demonstrates how the current price cap system is an extreme outlier in the postal sector. Other posts have been given significantly greater regulatory flexibility to implement rate increases for their market-dominant products as an important part of comprehensively adapting to changing marketplace conditions.

Because the current system is clearly failing to achieve the objectives, the Commission's responsibility is to move to the second stage of this proceeding and design a system that does achieve the objectives. Section VI discusses the alternative system that the Commission should put in place. While the Commission could theoretically attempt to design a more rational price cap system that seeks to correct the profound deficiencies of the current system, there is no reason for the Commission to attempt such an exercise, which is fundamentally unnecessary to achieve the objectives, and which would be both complex and fraught with risk given the uncertainty of the postal marketplace moving forward and the extreme sensitivity of the Postal Service's financial condition to the assumptions that would be used by the Commission in designing the new price cap formula. Rather, the Commission should enact a system of regulatory monitoring, supplemented by a requirement that the Postal Service provide forward guidance regarding the timing and magnitude of rate increases.

Under this proposed system, the Postal Service would be given the flexibility over its market-dominant products to allow it to successfully operate in the current marketplace, while the Commission would comprehensively monitor the Postal Service's rates, costs, financial condition, efficiency improvements, and service performance to ensure that all of the objectives are being achieved. The Commission could also supplement this ongoing monitoring with a forward guidance framework that requires the Postal Service to give mailers notice regarding the timing and magnitude of rate increases at the class and product level, in advance of a specific rate filing. The statutory structure is well-suited to the establishment of such a monitoring regime, considering the existence of the Annual Compliance Report/Determination and complaint processes, and the Commission's authority to require the production of information from the Postal Service.

The continuation of an *ex ante* price control is not necessary in order to achieve the objectives. Given the characteristics of the current and future postal marketplace, the Postal Service has strong inherent incentives to improve efficiency and to only set prices at levels that are needed to ensure its financial sustainability (i.e., without seeking excess profits), as well as inherent incentives to provide customers with appropriate rate predictability and stability, in order to not unnecessarily reduce volumes. In particular, given the vulnerability of the Postal Service to volume declines, as well as other factors that make the Postal Service's current circumstances very challenging, there is simply no basis to conclude that the Postal Service would either choose to set prices at excessive levels, or would feel free to lessen its efforts to cut costs and improve efficiency, if a price cap was not in place. A regime of monitoring and forward guidance would therefore ensure that these objectives are achieved. In addition, the combination of a forward guidance regime with no *ex ante* price control would provide mailers with a robust level of predictability.

Regarding the objective that the Postal Service be incented to reduce costs and increase efficiency, a review of the evidence clearly demonstrates that <u>mail volume trends</u> are a powerful motivating factor for the Postal Service to reduce costs and increase efficiency. A clear inflection point when it comes to the Postal Service's efforts in this regard can be discerned well before the PAEA was enacted, when it became evident that First-Class Mail volume was no longer tracking economic growth (and, in fact, was in absolute decline), and the Postal Service therefore undertook extensive efforts to cut costs and improve productivity. The cost reduction and efficiency gains of the post-PAEA period therefore reflect a <u>continuation</u> of trends that began prior to the PAEA. There is no basis to conclude that the price cap, as opposed to the volume declines, was the causal factor of the Postal Service's efforts to reduce costs and increase efficiency over the past decade.

Furthermore, Congress's decision to impose a price cap as an interim measure when it enacted the PAEA does not mean that a price cap should be retained in order to ensure that the Postal Service stays focused on cutting costs and increasing efficiency. Conditions have fundamentally changed since the enactment of PAEA, in a way that makes the Postal Service's situation exponentially more difficult than ten years ago. In 2006, Congress felt it prudent to use a price cap to ensure that the Postal Service kept a sharp focus on the need to cut costs and improve efficiency. That judgment may have made sense after only a relatively short period of sustained productivity growth and with the Postal Service still carrying 213 billion pieces of mail. As of 2017, however, mail volume has declined to "new normal" levels, and the Postal Service has a track record of aggressively pursuing cost reductions and efficiency savings for 17 years. As such, there is no rational basis to conclude that a price cap remains necessary today to ensure that the Postal Service continues to aggressively pursue efficiency gains.

The establishment of a regulatory monitoring regime, supplemented by a requirement of forward guidance, would not constitute a conclusion by the Commission that the Postal Service <u>lacks</u> market power under the statute. Rather, it would simply reflect a conclusion that the Postal Service lacks any real incentives to <u>abuse</u> any market power that it has, and that a properly designed system of regulatory monitoring is fully capable of ensuring that fact. Moving forward, the Commission would also have the ability to periodically review the operation of such a system and make adjustments as it deems appropriate: Congress has made clear that the Commission not only has the authority to design a new regulatory system ten years after enactment of the PAEA, but also that it has the ongoing authority to make revisions "as appropriate thereafter."

Such an approach would be similar to what has been established by the Office of Communications (Ofcom) in the United Kingdom. In 2012, Ofcom gave the postal operator, Royal Mail, the commercial flexibility to achieve the financially sustainable provision of universal service, which Royal Mail had not been able to do under the complex price cap structure created by Ofcom's predecessor, the Postal Services Commission (Postcomm). At the same time, Ofcom decided to monitor Royal Mail to ensure that it is pursing appropriate efficiency gains, not pricing in an excessive manner, and providing high-quality service. In doing so, Ofcom recognized that, due to the challenges of the postal marketplace, Royal Mail has inherent incentives to be efficient and not price in an excessive manner. Rather than attempting to design a price cap formula that attempts to reflect the complexities of the postal marketplace (as Postcomm continually tried, and ultimately failed, to do), the Commission should adopt Ofcom's much more straightforward regulatory approach. Indeed, Ofcom recently reaffirmed that its approach is the optimal way of ensuring the efficient, financially sustainable provision of high-quality universal service.

In conclusion, while the achievement of the objectives has heretofore been subordinated to the principles of the current price cap system, the Commission now has both the authority and the responsibility to design a regulatory structure that achieves the objectives. Any such regulatory structure must enable the Postal Service to fulfill its statutory mission and other statutory obligations in an efficient and financially sustainable manner. The current system does not do this. Congress enacted the PAEA to enable the Postal Service to adapt to the challenges of a rapidly evolving marketplace, rather than to consign it to a situation of perpetual financial distress. Like other posts, the Postal Service must have the opportunity to employ a comprehensive approach to adapting to changes in the marketplace, of which using rate increases for market-dominant products is one of a number of important tools. The Commission should grasp the opportunity to make the comprehensive regulatory reforms that are necessary to ensure that the Postal Service has the flexibility moving forward to provide high-quality universal postal services in an efficient and financially stable manner. The proposed regulatory monitoring and forward guidance regime would satisfy all of the statutory objectives.

II. THE COMMISSION'S RESPONSIBILITY IS TO EXAMINE WHETHER THE CURRENT PRICE CAP SYSTEM IS ACHIEVING THE OBJECTIVES, AND, IF NOT, TO DESIGN A SYSTEM THAT DOES

A. The Commission Has Broad Authority to Design an "Alternative System" in Order to Achieve the Objectives, Which Need Not be a Price Cap System.

There are two threshold, and interrelated, interpretative questions regarding Section 3622(d)(3). First, what aspects of the current regulatory structure governing market-dominant products are within "the system for regulating rates and classes for market-dominant products established under this section [i.e., Section 3622]," and hence are within the scope of the review? Second, what is the Commission's authority under the second step of the review to "make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives," if it concludes that the existing system is not achieving the objectives (taking into account the factors)?

Regarding the first question, the Commission states that it "intends to examine all aspects of the ratemaking system provided within section 3622"; that is, it intends to review the provisions of Sections 3622(d) and 3622(e).[2] The Commission is clearly correct in determining that the "system" that is subject to this review includes all provisions of Section 3622(d), including the current price cap and exigency provision. On the other hand, the Commission should not conclude that "system" includes the workshare discount provision of Section 3622(e). Regarding the second question, the statute clearly gives the Commission broad authority to replace the current price cap system with whatever regulatory system the Commission considers to be appropriate to achieve the objectives under current circumstances.

1. The current price cap system is clearly within the scope of the review.

The plain language of Section 3622(d)(3) clearly demonstrates both that the current price cap structure is within the scope of the "system" that the Commission is to review, and that the Commission is broadly authorized to replace the current price cap structure with whatever regulatory structure it deems necessary to achieve the objectives. These issues were discussed by the Postal Service in a previous submission to the Commission, which is attached as Appendix A.[3] As discussed therein, there is no reasonable dispute that the plain language of the statute places paragraphs (1) and (2) of Section 3622(d) (including the price cap and the exigency clause) within the scope of the "system" subject to this review: Section 3622(d) plainly states at the outset that its provisions are part of the "system for regulating rates and classes for market-dominant products." Furthermore, whatever the precise scope of

[2] Order No. 3673, Advance Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products, PRC Docket No. RM2017-3 (Dec. 20, 2016), at 2-3.

[3] The Postal Service submitted this document in response to a mailer white paper asserting that the Commission lacks the authority under Section 3622(d)(3) to replace the current price cap system.

"modification" might be, the fact that the Commission is also authorized to adopt an "alternative system" demonstrates that Section 3622(d)(3) imposes no limitations on the Commission's authority regarding the design of a replacement regulatory system, other than the requirement that any such replacement achieve the objectives.[4]

The plain language of Section 3622(d)(3) regarding both of these issues is reinforced by its legislative history. The earliest postal reform legislation contained detailed statutory requirements concerning a price cap system for market-dominant products, although the Commission would have had significant discretion regarding certain important elements of that system.[5] However, later House bills, including the House version of the PAEA passed in the 109th Congress, abandoned this approach and instead would have given the Commission the discretion to design what type of regulatory system the Commission considered to be appropriate, subject to achievement of specified statutory objectives.[6] This was the approach adopted by the version of the PAEA that the House passed in the 109th Congress.

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[4] "Alternative" is defined as "offering a choice of two or more things: offering for choice a second thing or proposition or other things or propositions." Webster's Third New International Dictionary, Unabridged (3d ed. 1986).

[5] H.R. 3717, 104th Cong. §§ 1001, 1002 (1996); Postal Reform Act of 1997, H.R. 22, 105th Cong. §§ 1001, 1002 (1997); Postal Modernization Act of 1998, H.R. 22, 105th Cong. §§ 201, 202 (1998); Postal Modernization Act of 1999, H.R. 22, 106th Cong. §§ 201, 202 (1999). In particular, the Commission was authorized to establish a adjustment factors to the price cap index.

[6] H.R. 22, 109th Cong. § 201 (2005); H.R. 4341, 108th Cong. § 201 (2004); H.R. 4970, 107th Cong. § 201 (2002). While these bills imposed an expectation that rates for each subclass should not exceed inflation, that expectation could be exceeded whenever it was found necessary to ensure quality service under efficient management, and the bills gave the Commission the authority to design a regulatory system other than a price cap: the Commission was broadly empowered to choose whatever regulatory structure it deemed appropriate to achieve the objectives, taking into account the factors. The purpose of giving the Commission this authority was to ensure that the regulatory system could "respond to changes in mail volume, technologies, and other factors." H.R. REP. NO. 109-66, pt. 1, at 48 (2005).

In the Senate, the earliest legislation would have required a price cap system, but otherwise empowered the Commission to design the specifics of that system, based on the achievement of the statutory objectives.[7] Subsequently, the Senate adopted a more prescriptive approach: instead of allowing the Commission to design the specifics of a price cap system, the Senate legislation would have required the imposition of a permanent CPI-U cap at the class level, which could only be exceeded in limited circumstances."[8] This was the approach adopted in the version of the PAEA that the Senate adopted in the 109th Congress.[9]

Ultimately, the House and Senate sponsors of the PAEA agreed to a compromise bill, which was introduced as H.R. 6407 at the end of the 109th Congress and enacted into law. This version adopted the Senate language regarding Section 3622, with two significant changes, one of which was the insertion of Section 3622(d)(3).[10] The PAEA's primary Senate sponsor, Senator Susan Collins, provided an authoritative explanation of this change upon introducing the compromise bill:

> The compromise legislation before the Senate replaces the current lengthy and litigious rate-setting process with a rate cap-based structure for products such as first class mail, periodicals, and library mail. For 10 years, the price changes for market-dominant products like these will be subject to a 45-day prior review period by the Postal Regulatory Commission. The Postal Service will have much more flexibility, but the rates will be capped at the CPI. That is an important element of providing 10 years of predictable, affordable rates, which will help every customer of the Postal Service plan.

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[7] S. 2468, 108th Cong. § 201 (2004); S. 1285, 108th Cong. § 201 (2003). *See also* S. REP. NO. 108-318, at 8 (2004) (noting authority of the Commission under S. 2468 to design the specific price cap system, believing that the Commission's "expertise to develop the price cap will result in a more flexible system that can be adapted to changing market conditions").

[8] S. 662, 109th Cong. § 201 (2005).

[9] *Id.* (as substituted by the Senate in an engrossed amendment to H.R. 22, 109th Cong. § 201, Feb. 9, 2006).

[10] The other change was a revised exigency provision.

> After 10 years, the Postal Regulatory Commission will review the rate cap and, if necessary, and following a notice and comment period, the Commission will be authorized to modify or adopt an alternative system.
>
> While this bill provides for a decade of rate stability, I continue to believe that the preferable approach was the permanent flexible rate cap that was included in the Senate-passed version of this legislation. But, on balance, this bill is simply too important, and that is why we have reached this compromise to allow it to pass. We at least will see a decade of rate stability, and I believe the Postal Rate Commission, at the end of that decade, may well decide that it is best to continue with a CPI rate cap in place. It is also, obviously, possible for Congress to act to reimpose the rate cap after it expires. But this legislation is simply too vital to our economy to pass on a decade of stability. The consequences of no legislation would be disastrous for the Postal Service, its employees, and its customers.[11]

As Senator Collins noted, while she would have preferred the Senate approach of mandating a permanent CPI-U cap, the PAEA instead gave the Commission the authority under Section 3622(d)(3) to "review the rate cap" and to "modify or adopt an alternative system."[12] She also noted that, ultimately, the question of whether to "continue with a CPI rate cap in place," or to set forth a modified or alternative system, is for the Commission to determine.[13]

As its language and history show, Congress's purpose in enacting Section 3622(d)(3) was to empower the Commission to ensure that the regulatory system governing market-dominant products is actually achieving the objectives that Congress intended the system to achieve, and, if not, to design a system that does. Rather than impose a CPI-based price cap (with a limited exigency safety valve) permanently, as the

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[11] 152 CONG. REC. S11,675 (daily ed. Dec. 8, 2006) (statement of Sen. Collins). As a primary sponsor of the PAEA, this statement "carries considerable weight." *See* Corley v United States, 556 U.S. 303, 318 (2009). Indeed, given the nature of the final version of the PAEA, which arose out of discussions between the House and Senate sponsors of the PAEA as opposed to a formal conference committee, this statement explaining the compromise is essentially the equivalent of a conference committee report regarding the meaning of Section 3622(d)(3).

[12] 152 CONG. REC. S11,675.

[13] *Id.*

Senate bill would have done, that cap was put in place as an interim measure for the first ten years, to be followed by the Commission's review. Moreover, if after its review the Commission makes the threshold determination that the current regulatory system is not achieving the objectives (taking into account the factors), the statute gives the Commission the responsibility to construct a system "to achieve the objectives," given current and anticipated circumstances. Indeed, considering the language of Section 3622 as a whole makes this responsibility plain: the Commission is required to establish a "modern" regulatory system that "shall be designed to achieve" the objectives.[14] "Modern" is a term whose plain meaning indicates evolution to account for, and adapt to, changing circumstances,[15] while "shall be designed to achieve" constitutes an "express directive" that the Commission ensure that the regulatory system is achieving the objectives.[16]

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[14] 39 U.S.C. § 3622(a)-(b).

[15] The definition of "modern" is "suitable to or expressive of the present time", "produced by or embodying the most recent techniques, methods, or ideas." Webster's Third New International Dictionary, Unabridged (3d ed. 1986).

[16] Time Warner Entm't Co. v. Fed. Commc'ns Comm'n, 56 F.3d 151, 176 (D.C. Cir. 1995) (noting that a provision stating that a regulatory system "shall be designed to achieve" a particular purpose was an "express directive" to the agency to effectuate that purpose). In this regard, it would be irrational to place any interpretative significance on the fact that Congress used the term "may" regarding the second step of this review. In particular, the use of "may" cannot rationally be interpreted as indicating that the Commission can decline to exercise its revisionary authority even if it finds the current system is not achieving the objectives. Such an interpretation could not be reconciled with the plain language of the statute when considered as a whole: now that 10 years has passed, if the Commission finds that the existing system is not achieving the objectives (taking into account the factors), it would clearly contradict Section 3622 as a whole to perpetuate a regulatory system that the Commission recognizes is not achieving the objectives. *Cf.* Util. Air Regulatory Group v. Envtl. Prot. Agency, 134 S. Ct. 2427, 2441 (2014) (noting the "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.") (citation omitted). The legislative history also does not support such a reading: the insertion of Section 3622(d)(3) was a critical compromise that was needed "to allow [the bill] to pass" precisely because Congress was not willing to accept the Senate approach of permanently enshrining the CPI-U cap, and thereby foreclose the system from being adapted to changing market conditions. Rather, the use of "shall" in the first sentence of Section 3622(d)(3) and "may" in the second sentence simply indicates that while the first step of the review is mandatory (the Commission must conduct a review of the current system), the second step is not: the establishment of a modified or alternative system is conditional on the Commission first

In inserting Section 3622(d)(3), Congress recognized that the postal marketplace was evolving and that, as circumstances changed, its interim decision to impose a CPI cap could prove unsuitable to achieving the policies that it intended the market-dominant regulatory system to effectuate.[17] Therefore, while Congress specified that the CPI cap was to be the "centerpiece" of the regulatory system set forth in the PAEA for the first 10 years following the existence of the PAEA,[18] it is no longer the case that achievement of the objectives is subordinated to the dictates of the CPI cap.[19] Furthermore, Congress also made clear that the Commission not only has the authority to design a new regulatory system ten years after enactment of the PAEA, if necessary to achieve the objectives, but also that the Commission has the ongoing authority to make revisions "as appropriate thereafter," to ensure that as circumstances continue to

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concluding that the current system is not achieving the objectives (taking into account the factors) and should therefore not be retained. The use of "may" also serves to indicate that the Commission has considerable discretion in determining how to revise the system (other than to ensure that the revised system achieves the objectives). In any event, even if the Commission theoretically has the authority to decline to revise the system even if it finds that the current system is not achieving the objectives, doing so would make no sense: it would clearly not serve the purposes of the PAEA to perpetuate a system that is failing to achieve the objectives.

[17] *See* H.R. REP. NO. 109-66, pt. 1, at 48 (noting that giving the Commission authority over the design of the regulatory system would ensure that the system could "respond to changes in mail volume, technologies, and other factors").

[18] *See, e.g.*, Order No. 1926, Order Granting Exigent Price Increase, PRC Docket No. R2013-11 (Dec. 24, 2013), at 15, 28.

[19] The Commission has previously noted that achievement of the objectives is a "secondary consideration" to adhering to the price cap. *See* Order No. 3441, Order Resolving Motion for Reconsideration of Commission Order No. 3047, PRC Docket No. R2013-10R (July 20, 2016), at 16-17 ("Under the section 3622 hierarchy, the price cap requirement is central, and the application of the objectives and factors are a secondary consideration. . . . Accordingly, under the system of ratemaking established by 39 U.S.C. § 3622 in 2006, there cannot be any exception to the price cap based on any objective or factor under the PAEA."); Postal Regulatory Comm'n, Annual Compliance Determination, Fiscal Year 2010, PRC Docket No. ACR2010 (Mar. 29, 2011), at 18-19 (explaining Section 3622's "hierarchy," wherein the requirements of subsections (d) and (e) (except for the provisions on exigent rate increases and unused pricing authority) "take[ ] precedence over the statutory pricing objectives and factors" in subsections (b) and (c)). These past remarks are an accurate depiction of the law in effect at the time, before Section 3622(d)(3) became active. However, the point of Section 3622(d)(3) is now to invert the hierarchy and test the price cap against the objectives and factors.

evolve moving forward, the regulatory system is capable of being adjusted to ensure that the objectives continue to be achieved.

2. The authority granted to the Commission by this review does not present constitutional concerns.

For reasons discussed more fully in Appendix A, it is baseless to assert, as certain mailer groups have previously done, that the Commission's authority under Section 3622(d)(3) presents constitutional concerns. The Commission's authority here is no different from that exercised by other regulatory agencies like the Federal Communications Commission (FCC) and the Federal Energy Regulatory Commission (FERC), which are also broadly empowered to design rate regulation systems to ensure the achievement of statutory policies. The fact that Congress specified that a CPI cap should be in place for the first ten years of the PAEA regime does not suddenly turn an unremarkable grant of regulatory power to the Commission into an unconstitutional conferral of legislative power.[20]

3. The new system does not have to contain a price cap.

In effectuating its responsibility under Section 3622(d)(3) to design a regulatory system that achieves the objectives, the Commission is not limited to only revising the price cap in a manner that attempts to correct the profound deficiencies of the current

[20] Furthermore, even if the Commission found there to be validity to those constitutional arguments, doing so would not affect its conduct of this review, for the reasons discussed in Appendix A. First, the constitutionality of Section 3622(d)(3) is a matter to be determined by the courts: as an administrative agency, the Commission cannot decline to exercise authority clearly conferred on it by Congress based on a conclusion that the authority is unconstitutional. In this regard, Congress clearly conferred upon the Commission the authority and responsibility to both review the current price cap, and to replace that cap with a modified or alternative system if it deems that the current system is not achieving the objectives. Second, it is also incorrect to believe that if Section 3622(d)(3) is unconstitutional, the appropriate remedy is to sever that provision from the PAEA while keeping the CPI-U price cap intact. Rather, the appropriate remedy would be to sever Section 3622(d) <u>in its entirety</u>, which would put the Commission in the same position of deciding what sort of "modern" system is necessary to achieve the objectives.

system. Nothing in the language of Section 3622(d)(3) indicates that the phrase "make such modification or adopt such alternative system as necessary to achieve the objectives" mandates the continuation of a price cap at all. Indeed, as noted above, the plain meaning of "alternative" is expansive, and does not support such a restricted reading. Nor does the statutory context suggest that "alternative system" should be read as containing an implicit qualifier: "alternative price cap system."[21] Rather than mandating the specific form of regulation, the Commission is broadly authorized under the statute to design whatever system it deems to be the best way to "achieve the objectives." As discussed below in section VI, the objectives do not compel the establishment of a price cap; rather, the objectives are under current circumstances best achieved through a system other than an *ex ante* price control.

The legislative history also does not provide any support for an argument that "alternative system" is implicitly limited to only a price cap system. To be sure, the establishment of a price cap system was the focus of the earliest House bills (though not, as discussed in section II.A.1 above, later House bills), as well as the Senate bills. However, this fact cannot reasonably be read to limit the plain language of the term "alternative" in Section 3622(d)(3), a provision which arose precisely because Congress did not want to permanently enshrine any particular regulatory approach. Indeed, these prior versions demonstrate that if Congress had wanted to mandate the application of a

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[21] *See* Adirondack Med. Ctr. v. Sebelius, 740 F.3d 692, 699-700 (D.C. Cir. 2014) (rejecting argument that statutory grant of authority to an agency was limited by noting that "we would need to engage in a statutory rewrite to do so – e.g., insert the word 'only' here and there, insert a limiting clause to the Secretary's otherwise broad grant of authority, etc.," which is "not our role"); Pub. Citizen, Inc. v. Rubber Mfrs. Ass'n, 533 F.3d 810, 816-17 (D.C. Cir. 2008) (declining to "add[ ] words that are not in the statute that the legislature enacted").

price cap system, with the Commission's discretion confined to the specific design elements of the cap, then Congress knew how to do so, and therefore would not have employed the expansive language that it did in Section 3622(d)(3).[22] Rather, the expansive language actually used is more consistent with the House bill, which broadly authorized the Commission to adopt the regulatory approach it considered appropriate.

As discussed further below, Congress's interest in establishing a price cap as the initial system to succeed the Postal Reorganization Act (PRA) regime was logical, because the PRA regime was a cost-of-service regime, and price caps had been used in other contexts to replace cost-of-service systems.[23] In particular, price caps were viewed at the time as correcting some of the perceived deficiencies in cost-of-service systems and therefore as logical successors to such systems. However, even though Congress thought a price cap appropriate when the PAEA was enacted, that fact is irrelevant to this exercise. Congress built into Section 3622 a timeline for review and potential modification or replacement of the price cap system that it put in place, and gave the Commission broad latitude to design whatever "modern" system it deems appropriate to achieve the objectives. Therefore, the Commission is no more compelled to maintain a price cap system than to keep the CPI cap itself, when a different regulatory approach is a better means of achieving the objectives under current circumstances.

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[22] Russello v. United States, 464 U.S. 16, 23-24 (1983) ("Where Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended."); Nat'l Pub. Radio, Inc. v. Fed. Commc'ns Comm'n, 254 F.3d 226, 230-31 (D.C. Cir. 2001).

[23] Of course, as discussed in section IV below, the specific design that Congress chose for the initial price cap system ultimately proved to be incapable of achieving the objectives, but that is a different question than whether to use a price cap system generally.

B. The Standards Set Forth by Congress to Govern Workshare Discounts Are Not Within the Scope of This Review.

In contrast to the price cap provisions set forth in Section 3622(d)(1)-(2), the standards governing workshare discounts set forth at Section 3622(e) is not within the scope of this review. In Order No. 3673, the Commission indicated a contrary conclusion, likely based on its determination that the provision “regulate[s] rates and classes for market-dominant products,” and is found within Section 3622. However, the scope of Section 3622(d)(3) does not extend to all provisions that regulate market-dominant rates and classes in a general sense; rather, it applies specifically to the “system” for doing so. Other provisions, such as Section 3626 and Section 101(d), “regulate rates and classes for market-dominant products,” but the Commission has correctly determined that they are not part of the “system” to be reviewed in this proceeding. When the language of Section 3622(e) and the structure of Section 3622 as a whole are examined, it is clear that the workshare discount standards are not within the “system” as that term is used in Section 3622(d)(3), notwithstanding their formal placement within Section 3622. This interpretation is supported by the legislative history of the PAEA.

An examination of the language of Section 3622 shows that the provision is quite precise as to which provisions fall within the scope of the “system.” Subsections (a) through (d) of Section 3622 expressly set forth the parameters of the “system”: subsection (a) says that the Commission shall establish the “system” (and revise the “system” as needed), subsection (b) sets forth the objectives that the Commission must design the “system” to achieve, subsection (c) sets forth the factors that the Commission must “take into account” when designing the “system,” and subsection (d) contains requirements about the initial contours of the “system” (i.e., the current price cap and exigency provision). At the end of these provisions comes Section 3622(d)(3), with its provision for the Commission’s 10-year review of the “system,” and for subsequent reviews thereafter, in order to ensure that the objectives governing the design of the “system” are achieved.

The workshare discount standards in subsection (e) follows the 10-year review provision. In sharp contrast to subsections (a) through (d), all of which expressly reference the “system,” subsection (e) does not specify that its standards are an aspect of the “system.” Rather, the workshare provision contains a simple command to the Commission: it “shall ensure that [workshare] discounts do not exceed the cost that the Postal Service avoids as a result of workshare activity,” unless certain conditions are met. This command applies independently of however the Commission might otherwise design the “system” pursuant to Section 3622. Moreover, the reference to “subsection (a)” in the first subsection of Section 3622(e) does not alter the unadorned nature of this command: that provision simply clarifies that the Commission has authority to “further <u>define”</u> the meaning of “workshare discounts” to which the command applies.

Interpreting the standards of Section 3622(e) as not being within the “system” does not render the phrase “established under this section” in Section 3622(d)(3) surplusage. That phrase has operative meaning because it clarifies that “system” is not a generic term, such that it might encompass any provision that regulates market-dominant products, but instead has a precisely drawn meaning. Thus, for instance, it makes it clear that Congress did not intend the Commission to have the authority to alter the rules concerning preferred rates, which are to “be established in accordance with section 3622" (and thus in a general sense are within the market-dominant regulatory system).[24] Hence, the fact that the workshare discount standards of Section 3622(e) regulate market-dominant rates (and are within the system in a generic sense) is not the dispositive question. Rather, the question is whether those standards are within the "system" according to the specific meaning that Congress gave that term in Section 3622. As discussed above, it is not.[25]

Overall, Congress inserted two mandatory elements concerning the regulation of market-dominant rates and classes into Section 3622: the price cap and the requirement that "workshare discounts" (as defined by the statute and further defined by the Commission) not exceed their costs avoided. It also clearly specified that the former was only a mandatory element for the first 10 years following the PAEA, but put no such clear time-limit on the mandatory nature of the latter. As such, the logical inference is that Congress did not intend to time-limit the command that workshare discounts not exceed their costs avoided unless the statutory conditions are satisfied.

The legislative history of the PAEA also demonstrates that Congress considered the requirement that workshare discounts not exceed avoided costs as an independent command that applied regardless of the specifics of the regulatory system created by

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[24] 39 U.S.C. § 3626(a)(1). *See also* Webster's Third New International Dictionary, Unabridged (3d ed. 1986) (defining "system" as "a complex unity formed of many often diverse parts subject to a common plan or serving a common purpose").

[25] Moreover, even if the Commission concludes that this interpretation would render the phrase redundant, the canon against surplusage "is not an absolute rule." Marx v. Gen. Revenue Corp., __ U.S. __, 133 S. Ct. 1166, 1177 (2013). This is because Congress "sometimes employ[s] overlap or redundancy so as to remove any doubt and make doubly sure." Loving v. Internal Revenue Serv., 742 F.3d 1013, 1019 (D.C. Cir. 2014). *See also* Arlington Cent. Sch. Dist. Bd. of Educ. v. Murphy, 548 U.S. 291, 299 n. 1 (2006) (noting that "[w]hile it is generally presumed that statutes do not contain surplusage, instances of surplusage are not unknown."). Therefore, the Commission should not decline to read the statute in accordance with the best reading of its language and legislative history simply to avoid some redundancy.

the Commission under Section 3622. While the House version of the PAEA allowed the Commission to create a regulatory structure to achieve the objectives (taking into account the factors) under Section 3622, it specified in a separate section that the Commission had to ensure that workshare discounts not exceed their avoided costs.[26] Meanwhile, in an early version of the Senate bill, while the workshare discount provision was included in Section 3622, the Commission's discretionary authority to design a price cap "system" to achieve the objectives (taking into account the factors) was distinct from the rules regarding workshare discounts: the Commission was required to ensure that such discounts did not exceed their avoided costs.[27] This separation between the price cap and the workshare discount rules was carried forward into the later Senate versions, which hardwired both a CPI price cap (thereby taking away the Commission's authority in earlier bills to design the price cap system) and the workshare discount command.[28]

Therefore, the legislative history indicates that Congress treated the workshare discount standards as being distinct from the other elements of the regulatory structure set forth in Section 3622. Both the House and Senate specified that the Commission had to ensure that workshare discounts not exceed their avoided costs; they disagreed only as to whether the Commission should have the authority to design the system governing ratemaking generally, with the Senate eventually preferring a permanent CPI

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[26] H.R. 22, 109th Cong., §§ 201, 206 (as passed by the House July 26, 2005). *See also* H.R. REP. NO. 109-66, pt. 1, at 46-48, 53.

[27] S. 2468, 108th Cong. § 201. *See also* S. REP. NO. 108-318, at 8, 12-13, 40, 43.

[28] S. 662, 109th Cong. § 201 (as substituted by the Senate in an engrossed amendment to H.R. 22, 109th Cong. § 201, Feb. 9, 2006).

price cap and the House preferring to give the Commission broad authority. As noted in section II.A.1 above, Section 3622(d)(3) was a late compromise between those two opposing positions that, as Senator Collins noted, was needed to "allow [the PAEA] to pass."[29] Given this history, it is counterintuitive to read Section 3622(d)(3) as also giving the Commission the authority to revise the workshare discount standards specified by Congress.

Furthermore, in previously discussing the workshare provision, the Commission has indicated its view that the workshare discount standards of Section 3622(e) are separate and distinct from the other provisions of Section 3622, including the objectives and factors that underlie the review under Section 3622(d)(3).[30] In particular, the Commission has described those standards, like Section 3626, as being within "a self-contained section of the PAEA" separate from Section 3622(d).[31] The Commission went on to explain that Section 3622(e), like Section 3626, is "objective, quantitative, and mandatory," and that the two provisions are "prescribed by statute" and "leave only narrow aspects to the Commission's discretion."[32] These statements are consistent with the language and legislative history of the PAEA discussed above, and the Commission should therefore conclude that Congress did not give it the authority in this review to revise the standards governing workshare discounts set forth in Section 3622(e).

III. THE OBJECTIVES ARE ACHIEVED THROUGH A REGULATORY SYSTEM THAT ENABLES THE POSTAL SERVICE TO PROVIDE EFFICIENT AND

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[29] 152 Cong. Rec. S11,675 (daily ed. Dec. 8, 2006) (statement of Sen. Collins).

[30] *See* Order No. 536, Order Adopting Analytical Principles Regarding Workshare Discount Methodology, PRC Docket No. RM2009-3 (Sept. 14, 2010), at 16-19, 34-37.

[31] *Id.*

[32] *Id.*

FINANCIALLY SUSTAINABLE UNIVERSAL SERVICE IN AN EVOLVING POSTAL MARKETPLACE

The Commission's responsibility is therefore to review whether the statutory objectives that Congress intended the market-dominant regulatory system to achieve are in fact being achieved by the current price cap system (taking into account the factors), and, if not, to design a system that does achieve the objectives. The Commission has noted that these objectives set forth policies that are "sometimes competing."[33] Nevertheless, each is to be applied "in conjunction with the others," which means that each objective must be appropriately accommodated and balanced within the regulatory system.[34] There is not an appropriate balance if the system is failing to achieve one or more objectives. In this regard, the achievement of one objective cannot be pursued in a way that "wholly undermines" another, co-equal objective.[35]

The objectives set forth policies that are usefully considered as applying at two levels. At their broadest level, the objectives require the market-dominant regulatory system to enable the Postal Service the opportunity to generate adequate revenues from its market-dominant products so that, in combination with the revenues generated

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[33] *See, e.g.*, Order No. 1926 at 37. *See also* Laying Out the Reality of the United States Postal Service: Hearing Before the S. Comm. on Homeland Sec. and Govtl. Affairs, 114th Cong. (2016) (written testimony of Robert G. Taub, Acting Chairman of the Postal Regulatory Commission), at 27; Postal Regulatory Comm'n, Annual Report to the President and Congress, Fiscal Year 2016 (Jan. 1, 2017), at 24.

[34] *Laying Out the Reality of the United States Postal Service: Hearing Before the S. Comm. on Homeland Sec. and Govtl. Affairs*, 114th Cong. (2016) (written testimony of Robert G. Taub, Acting Chairman of the Postal Regulatory Commission), at 27.

[35] See Nat'l Ass'n of Regulatory Util. Comm'rs v. Interstate Commerce Comm'n, 41 F.3d 721, 728 (D.C. Cir. 1994) (finding an agency interpretation of statute with conflicting policy goals to be unreasonable because it "favors the interests of one in a manner that wholly undermines those of the other"); Pub. Serv. Co. of Indiana, Inc. v. Interstate Commerce Comm'n, 749 F.2d 753, 765 (D.C. Cir. 1984) (noting that in a statute that sets forth various factors governing ratemaking, "[o]ne statutory factor cannot be . . . blindly exalted at the expense of others that are at least co-equal in importance").

from competitive products, it can achieve its universal service mission and fulfill its other statutory obligations in a financially stable manner, while exercising efficient management. At a narrower level, the objectives require that the system enable the Postal Service to exercise the flexibility over rate and mail classification standards to advance its business goals, subject to Commission review to ensure compliance with legal standards, while also providing mailers with predictable and stable rates. Some of the objectives set forth policies that are directly relevant to both levels, while other objectives deal with only one of these levels.

In addition to the objectives, the Commission must "take into account" the factors of Section 3622(c).[36] As the Commission appropriately recognizes, the factors are clearly secondary to the objectives: while the system "shall be designed to achieve" the objectives, the Commission need only "take into account" the factors.[37] To effectuate its responsibility "to take into account" the factors, the Commission must "reach an express and considered conclusion about the bearing of a factor, but is not required to give any specific weight to it."[38] In some respects, the factors set forth considerations that overlap with the objectives: for example, Objective 1 and Factor 12, and Objective 4 and

[36] While Section 3622(d)(3) expressly notes that the Commission must "take into account" the factors as part of reviewing whether the regulatory system should be modified or replaced, it does not state explicitly that the Commission must "take into account" the factors when considering any modified or alternative system. This reflects that the touchstone for establishing any modified or alternative system is whether such a system is necessary to achieve the objectives. Section 3622(c) requires the Commission to "take into account" the factors whenever it is "establishing or revising" the system, so it would be logical for the Commission to take the factors into account when performing both stages of this proceeding.

[37] Order No. 3673 at 3. *Accord* Time Warner, 56 F.3d at 175-76 (distinguishing between statutory provision setting forth an express directive to agency, through language stating that the regulatory regime "shall be designed to achieve" a particular policy, and a statutory provision simply obliging the agency to "consider" certain other statutory policies).

[38] *Time Warner*, 56 F.3d at 175 (internal quotation marks and citation omitted).

Factor 7. In these instances, the Commission's consideration of the objective necessarily means that it is also "taking into account" the associated factor.[39]

In Order No. 3673, the Commission sets forth preliminary definitions for each objective, and also proposes potential means to measure whether the objectives are being achieved. The Commission's Order is generally reasonable regarding both of these issues, although certain clarifications and refinements are appropriate. In the remainder of this section, the Postal Service discusses how the objectives should be applied, with a particular emphasis on the most fundamental issue facing the Commission: how to apply the objectives in a manner that effectuates Congress's purpose to create a Postal Service that is both efficient and financially stable.

A. Congress's Purpose in Establishing the Objectives Was to Replace the Prior Ratemaking Regime with a System Suited to an Evolving Marketplace.

A central purpose of postal policy since the creation of the Postal Service in 1970 is that fulfill its universal service mission and other statutory obligations in a financially self-sufficient manner.[40] The pre-1971 Post Office Department was dependent on large Congressional appropriations to cover its operating deficits; by contrast, Congress sought in the PRA to enable the Postal Service to achieve its mission in a more

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[39] Factor 10 sets forth the standards concerning market-dominant negotiated service agreements (NSAs) that underlie the Commission's rules on that subject. 39 C.F.R. § 3010.40. The Postal Service interprets Order No. 3673 as indicating that these rules are not within the scope of this review.

[40] *See, e.g.*, Direct Mail Advert. Ass'n v. U.S. Postal Serv., 458 F.2d 813, 817 (1972) (noting that a "central purpose of the [PRA was] to place the Postal Service on a self-sufficient basis"); Op. & Rec. Dec., PRC Docket No. R87-1 (Mar. 4, 1988), at 17 (noting that "the central mandate" of the PRA was "a Postal Service that is self-sufficient and financially stable"); Op. & Rec. Dec., PRC Docket No. R77-1 (May 12, 1978), at 43 ("a central purpose of the [PRA] was to create a financially stable and self-sufficient Postal Service").

business-like manner and to eventually become self-sufficient.[41] In the PAEA, Congress reaffirmed this fundamental policy, and sought to ensure its continued achievement by enhancing the Postal Service's ability to operate successfully within a changing – and more challenging – postal marketplace.

In particular, whereas for decades the Postal Service had experienced steady mail volume growth, Congress recognized that electronic communications alternatives were fundamentally changing the role of the mail within society and hence reducing demand for First-Class Mail, the product that provides the bulk of the contribution to covering the Postal Service's institutional costs.[42] First-Class Mail volumes peaked in FY2001, and thereafter began a gradual decline. Congress's goal in the PAEA was to give the Postal Service an enhanced ability to continue to meet its statutory mission in a self-sufficient manner by, among other things, revamping the regulatory regime by which postal rates are set.[43]

The ratemaking regime set forth in the PRA was deemed by Congress to be unsuited to a marketplace characterized by these more challenging mail volume trends.

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[41] Appropriations are therefore authorized in only limited circumstances, as set forth in 39 U.S.C. § 2401. *See generally* Op. & Rec. Dec., PRC Docket No. R76-1 (June 30, 1976) (noting that appropriations set forth in that section are "a recognized and limited exception to the general policy of self-sufficiency"). Consistent with the principle of self-sufficiency, the Postal Service has not sought an operational appropriation since the early 1980s.

[42] S. REP. NO. 108-318, at 3; H.R. REP. NO. 109-66, pt. 1, at 42. *See also* PRESIDENT'S COMM'N ON THE U.S. POSTAL SERV., EMBRACING THE FUTURE: MAKING THE TOUGH CHOICES TO PRESERVE UNIVERSAL MAIL SERVICE 1-8 (2003) [hereinafter "President's Commission Report"].

[43] Congress's goal in the PAEA was to protect universal service "by giving the Postal Service the ability to remain viable and effective." H.R. REP. NO. 109-66, pt.1, at 44. The Commission has also recognized that one goal of the PAEA was to help ensure that the Postal Service remained self-financing. Order No. 547, Order Denying Request for Exigent Rate Adjustment, PRC Docket No. R2010-4 (Sept. 30, 2010), at 6. As explained in section IV below, however, Congress did not appreciate the drastic impact of the volume shifts that were to come when it selected the interim CPI-based price cap.

The central legal underpinning of the PRA regime was a "breakeven over time" requirement, which required that, from the standpoint of net income, the Postal Service was to neither make a loss nor generate a profit over time,[44] and as a practical matter required the Postal Service to wait multiple years between rate increases.[45] In addition, under the PRA, rate and classification changes for all products could only occur through elaborate, on-the-record litigation in which final authority over rate design rested with the Commission.[46] The combination of the breakeven standard and the formal rate case process was seen as creating an outmoded regulatory structure that did not give clear legal incentives to the Postal Service, unduly limited the Postal Service's financial and pricing flexibility, and led to periodic rate increases that customers criticized as not being sufficiently predictable and stable.[47] Moreover, the regime was viewed as not being sufficiently transparent, since the Commission generally had limited authority to require the production of information on an ongoing basis, outside of specific rate or classification proceedings. Congress sought in the PAEA to create a legal structure that would correct these deficiencies of the PRA's rate-regulation system.

Congress viewed the breakeven standard as not setting forth appropriate legal incentives for the Postal Service. It considered that for the Postal Service to "operate in

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[44] *See* 39 U.S.C. § 3621 (2006) (setting forth breakeven standard). *See, e.g.*, PRC Op. & Rec. Dec., PRC Docket No. R90-1 (Jan. 4, 1991), at II-28 (noting that "breakeven over (a reasonable period of) time" is "a proper reading of the [PRA's] financial policy") (citing Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Service, 607 F.2d 392, 431-32 (D.C. Cir. 1979)).

[45] Because of the restrictions of the breakeven standard, the Postal Service could only raise rates when it could demonstrate actual or planned expenditures in the test year that made the increase necessary. *Cf.* Op. & Rec. Dec., PRC Docket No. R97-1 (May 11, 1998), at 31-32, 39-41 (allowing rate increase but expressing concern that the test year adhered to the "as nearly as practicable" requirement only because of planned, rather than actual, expenditures).

[46] 39 U.S.C. §§ 3622-3625 (2006).

[47] *See, e.g.*, S. REP. NO. 108-318, at 6-8.

a more business-like manner," there had to be "clear incentives for postal management and the Postal Service as an institution."[48] On the one hand, the breakeven standard mandated that total revenues "equal as nearly as practicable total estimated costs of the Postal Service,"[49] and the Commission had limited (or at least disputed) authority to control the Postal Service's ability to determine what revenues were required to cover the Postal Service's costs.[50] Indeed, the Postal Service's Governors ultimately retained the authority to reject any Commission recommended decision that they deemed to provide insufficient revenues.[51] On the other hand, the breakeven standard also limited the Postal Service's ability to pursue net income, or "retained earnings."[52] For instance,

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[48] H.R. REP. NO. 109-66, pt. 1, at 43.

[49] 39 U.S.C. § 3621 (2006). Any cumulative net loss that developed between rate cases was therefore recovered through a mechanistic Prior Year Loss (PYL) process, in which a portion of the cumulative net loss since the enactment of the PRA was added to the revenue requirement. *See, e.g.*, Op. & Rec. Dec., PRC Docket No. R90-1 at II-28 (noting that "breakeven over (a reasonable period of) time . . . requires some PYL mechanism").

[50] *See* Newsweek v. U.S. Postal Serv., 663 F.2d 1186, 1203-1206 (2d Cir. 1981) (rejecting Commission recommended decision that "drastically reduced the Postal Service's revenue requirements" and "had the effect of undermining the Board's exclusive authority in timing changes in postal rates and fees"). *See also* Governors of the U.S. Postal Serv. v. U.S. Postal Rate Comm'n, 654 F.2d 108, 113-17 (D.C. Cir. 1980) (noting limited authority of Commission under PRA regime as being "strictly confined to relatively passive review of rate, classification, and major service changes") (citations omitted). There were also disputes between the Postal Service and the Commission regarding the latter's authority under the PRA to disallow costs as being inconsistent with honest, efficient, and economical management, or to adjust the size of the contingency amount. Op. & Rec. Dec., PRC Docket No. R2000-1 (Nov. 13, 2000), at 62-64 (noting and rejecting Postal Service position that Governors had authority to determine the size of the contingency); *id*. at 37 (noting, regarding the disallowance of costs, that "the Commission holds opinions on the extent of its role vis-à-vis the revenue requirement that diverge from those argued by the Postal Service").

[51] 39 U.S.C. § 3625(d). The Governors exercised this authority on two occasions, in the R80-1 and R2000-1 rate cases.

[52] *See* Op. & Rec. Dec., PRC Docket No. R2000-1 at 75 ¶ 2171 (noting that a test year profit "has never been a legitimate objective of ratemaking under the [PRA]."); Op. & Rec. Dec., PRC Docket No. R76-1 at 45 (noting that the PRA "is so structured as to make it clear that the [Postal] Service was not to seek a profit"). *See also* Op. & Rec. Dec., PRC Docket No. R2005-1 (Nov. 1, 2005), at 23 ¶ 3002 (defining "retained earnings" as "total cumulative net income"). The precise treatment of any retained earnings that nevertheless developed between rate cases was never definitively resolved under the PRA in a manner similar to the treatment of a cumulative net loss, because the Postal Service did not generate retained earnings until near the end of the PRA regime, due to a combination of rate increases, the passage of Public Law No. 108-18, and the Postal Service's accelerated efforts to reduce costs, and increase

the Commission noted that the breakeven requirement specifically required the inclusion of a contingency amount in part because it inhibited the Postal Service's ability to generate "retained earnings" that could be relied upon as a source of funds to ensure financial sustainability as business conditions changed.[53]

Congress eliminated the breakeven standard in the PAEA to ensure a more flexible ratemaking system whose underlying legal principles aligned with the need for the Postal Service to reduce costs and increase efficiency as the postal marketplace became more challenging. While there was widespread recognition that the Postal Service was in fact undertaking significant efforts to achieving costs savings and improve efficiency (discussed below), the principles of the PRA regime meant that "[t]he current rate-setting process provides little or no incentive for the Postal Service to control its costs because all costs are ultimately passed through to the consumer regardless of how efficiently or inefficiently the Postal Service operates."[54] Congress

efficiency. However, there was general recognition that there were limits on the Postal Service's ability to generate retained earnings under the statute. Op. & Rec. Dec., PRC Docket No. R2005-1 at 26-31 (noting that the Postal Service was in the "unprecedented financial position of having realized sufficient net earnings since the last omnibus rate case" that it had retained earnings rather than a cumulative net loss, that several parties had asserted that those retained earnings were unauthorized and thus had to be taken into account when considering the Postal Service's revenue requirement, and that the Commission would defer the question as to the specific treatment of retained earnings given the unique nature of the case).

[53] Op. & Rec. Dec., PRC Docket No. R76-1 at 53 ("Unlike most other regulated enterprises, the Postal Service is operated on a break-even basis. It has no retained earnings on which to rely during periods of financial stringency. Being untaxed, it does not maintain tax reserves which can be drawn down during short-term cash deficiencies. In sum, the contingency provisions plays a preeminent role--which in most private enterprises is assumed by a variety of other financial devices--in insuring the ability of the system to continue rendering service to mailers.").

[54] H.R. REP. NO. 109-66, pt. 1, at 48 (emphasis added). *See also* S. REP. NO. 108-318, at 6; Order No. 1926 at 14 (noting that "there was major concern that the PRA's ratemaking process lacked incentives for the Postal Service to operate efficiently or control costs"); *The Road Ahead: Implementing Postal Reform: Hearing Before the Subcomm. On Fed. Fin. Mgmt., Gov't Info., Fed. Servs., and Int'l Sec. of the S. Comm. on Homeland Sec. and Govtl. Affairs*, 110th Cong. 2 (2007) (statement of Chairman Carper) ("[A]t the end of the day, the Postal Service was given little incentive through [the PRA] rate system to modernize its organization and modernize its operations because they were essentially entitled to receive

wanted to ensure that, moving forward, the statute made it clear that the Postal Service could no longer operate on the assumption that costs could invariably be recovered through rate increases. At the same time, eliminating the breakeven standard and allowing for retained earnings also ensured that the statute would not potentially discourage the Postal Service from continuing to seek cost reductions and efficiency gains.[55]

In addition, by eliminating the breakeven regime and the rate case procedures, Congress wanted to give the Postal Service greater flexibility, both in terms of its overall ability to use rate increases as a tool for a business-like financial policy within an evolving marketplace, and in terms of its ability to determine the specifics of its rate design. In exchange, Congress enhanced and clarified the Commission's authority to ensure that the Postal Service conforms to statutory standards.[56] Furthermore, whereas the restrictions of the breakeven standard and the litigious rate case process typically led to rate cases that were spaced multiple years apart, the Postal Service could now pursue rate changes through more frequent, streamlined rate cases that would provide mailers with greater predictability and allow rates to increase in a more stable manner.

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whatever price increases they needed to cover their costs, whatever those costs might be."). As discussed further below, while the rate system itself may have not provided clear legal incentives for the Postal Service to be efficient, that does not mean that other factors—in particular, declining contribution-weighted mail volume per delivery point—did not provide such an incentive.

[55] S. REP. NO. 108-318, at 8-9.

[56] Congress therefore gave the Commission the authority to order the Postal Service to take remedial action if the Commission finds that the Postal Service is not complying with the law. 39 U.S.C. §§ 3653, 3662. The Commission was also given the authority to require the Postal Service to produce information. *Id.* §§ 504(f)-(g), 3652(d)-(f), 3654(d)-(f).

Therefore, to achieve these goals, Congress in the PAEA replaced the PRA regime with a revamped ratemaking structure. With respect to products designated as market-dominant, Section 3622 requires the Commission to design a “modern” regulatory system that achieves a set of objectives intended to create “increased flexibility, predictability, incentives for efficiency, and long term financial stability,”[57] In order to “ensure that the Postal Service remains a financially viable institution capable of providing the mail services that the American public needs.”[58] The breakeven standard was replaced with objectives specifying that the regulatory system must enable the Postal Service to set “just and reasonable” rates that give it the opportunity to generate adequate revenues to maintain “financial stability,” provide “high-quality service standards,” and ensure the security of the mail, while at the same time ensuring that the Postal Service has “maximum incentives to reduce costs and increase efficiency.” Congress expressly included within the concept of “financial stability” an allowance for “retained earnings.” Congress also eliminated the PRA rate and classification system and established objectives that any modern ratemaking system both minimize administrative burdens and be more transparent, as well as enable the Postal Service to have “pricing flexibility” while being responsive to the customer need for rates that are “predictable and stable.” Finally, Congress also included an objective regarding the appropriate allocation of institutional costs between the Postal Service’s

[57] H.R. REP. NO. 109-66, pt. 1, at 46.

[58] S. REP. NO. 108-318, at 8.

market-dominant products and competitive products, to ensure congruence between the two regulatory regimes established under the PAEA.[59]

Furthermore, as discussed in section II.A above, Congress specified that the PRA regime should initially be replaced by a price cap system, and it also dictated the specific design of that system. It was understandable for Congress at the time to view a price cap as being the appropriate mechanism to replace the PRA regime and achieve the objectives. Indeed, price caps had replaced cost-of-service regimes in other regulated industries because they were seen at the time as addressing the deficiencies of cost-of-service regulation. In particular, cost-of-service regimes were seen as administratively burdensome and as providing insufficient incentives for a regulated firm to increase efficiency, both because regulated entities could generally be assured of covering their costs, and because any earnings generated through efficiency gains would be used to offset the size of any future rate increases.[60] Price caps were viewed as a more effective regulatory approach because they incent a firm to be more efficient. If a firm can be more efficient than assumed when a price cap is designed, then the firm has the opportunity to retain higher earnings than under cost-of-service regulation; conversely, a firm with less-than-assumed efficiency would suffer lower earnings than what would be allowed under cost-of-service regulation.[61] Moreover, a price cap

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[59] The PAEA also imposes other requirements to ensure that competitive products, both individually and collectively, cover their costs. 39 U.S.C. § 3633. The requirement that competitive products cover their incremental costs ensures that they are not cross-subsidized by market-dominant products.

[60] *See, e.g.*, In the Matter of Policy & Rules Concerning Rates for Dominant Carriers, 4 F.C.C. Rcd. 2873, 2899-2933 (1989) (discussing the merits of a price cap system and the problems associated with a rate-of-return system).

[61] Appendix E at 14-15. Therefore, as discussed further in section IV below, while price cap systems inhere a downside risk of lower earnings compared to cost-of-service systems, they were not intended to jeopardize the regulated firm's ability to remain financially viable.

system allows for more streamlined regulatory procedures after a price cap is set (at least assuming the assumptions underlying the design of the price cap remain valid, meaning the formula does not need to be re-examined), and also was viewed as giving the firm greater pricing flexibility.

Congress in particular saw the imposition of a price cap as important to ensuring that the Postal Service kept a sharp focus on achieving efficiency gains. Congress, the Commission, and other entities recognized that, even under the PRA cost-of-service regime, the Postal Service had already begun to substantially reduce its costs and improve its productivity in response to the challenges presented by electronic diversion.[62] Nevertheless, Congress felt it prudent at that time to employ a price cap to make sure that the Postal Service continued to be incented to reduce costs and increase efficiency. For instance, as Senator Carper noted soon after the PAEA was

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[62] *See* S. REP. NO. 108-318, at 2-3 (noting the Postal Service's "aggressive cost-cutting"); President's Commission Report at 2; Op. & Rec. Dec., PRC Docket No. R2005-1 at ¶ 5022 (noting that the limited size of the Postal Service's rate request was a "testament to the Postal Service's cost cutting efforts and improved productivity"). *See also The Report of the Presidential Commission on the U.S. Postal Service: Preserving Access and Affordability: Hearing Before the S. Comm. on Govtl. Affairs*, 108th Cong. 9 (2003) (statement of Chairman Susan Collins) (noting that the Postal Service had "made great strides in reducing inefficiencies, improving service and productivity, strengthening labor relations, and cutting costs."); *U.S. Postal Service: What Can Be Done to Ensure Its Future Viability?: Hearing Before the S. Comm. on Govtl. Affairs*, 108th Cong. 19 (2003) (statement of James A. Johnson, Co-Chair, Presidential Commission on the U.S. Postal Service) ("The second thing that has changed the dynamic of urgency is the skill of the Postmaster General and the leadership of the Postal Service. Their Transformation Plan, their efforts to put best practices in place, are bearing substantial dividends. They are moving forward on a wide variety of fronts, and I tried in every one of our nine public meetings to compliment them. I do not want to fail to do that today because I think excellence in Federal service should be recognized systematically, and I think many of the things that they are doing are very impressive."); Official Transcripts of Hearing Held on June 27, 2005, Vol. 2, PRC Docket No. R2005-1, (June 28, 2005), at 46-47 (statement of Chairman George Omas) ("Since Jack Potter became postmaster general, the Postal Service has experienced a remarkable revitalization. Productivity has improved, service has improved, and employee morale has improved. I have observed a new, can-do attitude which has resulted in unprecedented progress toward making the Postal Service a model for the rest of the world.")

enacted, imposing a price cap would ensure that these efforts continued.[63] As discussed above, however, Congress also recognized that the specific price cap system it put in place might not enable the objectives to actually be achieved as circumstances changed, and therefore gave the Commission its authority under Section 3622(d)(3).[64]

B. Achieving the Objectives Requires a Postal Service That Is Capable of Being Financially Stable Through the Exercise of Efficient Management.

Consistent with the foundational postal policy that the Postal Service be self-sufficient, rather than reliant on taxpayer subsidies, several of the objectives address the Postal Service's overall financial integrity: that is, the Postal Service's ability to generate sufficient revenues from market-dominant products so that it has the ability to meet its statutory obligations – including its "basic function" of providing universal postal services[65] – in a self-sufficient manner. Two objectives (Objectives 5 and 8) specifically require any regulatory system to ensure the Postal Service's financial stability. Furthermore, several other objectives (Objectives 1, 3, 4, and 7) can only be achieved if

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[63] *The Road Ahead: Implementing Postal Reform: Hearing Before the Subcomm. on Fed. Fin. Mgmt., Gov't Info., Fed. Servs., and Int'l Sec. of the S. Comm. on Homeland Sec. and Govtl. Affairs*, 110th Cong. 2 (2007).

[64] Given the purposes of this review and any subsequent review, as well as the legal relationship between the price cap and the objectives generally, the interpretation of the objectives themselves must be system-neutral; it cannot be dependent on the interim choice Congress made for the 10-year period following the PAEA. While the Commission can certainly conclude that the CPI-U price cap achieves a particular objective, it cannot rationally interpret any objective as requiring the current price cap system. Certain parts of Order No. 3673 can be read as blurring the fundamental distinction between the current price cap and the objectives. In particular, the Commission preliminarily defines Objective 1 as a system that "uses available mechanisms, such as flexibility under the price cap, pricing differentials, and workshare discounts, to the fullest extent possible to incentivize the reduction of costs and increases in operational and pricing efficiency." Order No. 3673 at 4 (emphasis added). However, it would be incorrect to conclude that Objective 1 itself embodies currently "available mechanisms," such as "the price cap." Rather, the objective requires that the Commission design a system that provides "maximum incentives" (given statutory constraints) to reduce costs and increase efficiency, and the current system, or any alternative system that is considered, must be assessed as to whether it appropriately achieves that objective. Similarly, nothing in the "stability" objective mandates that CPI is the proper measure of determining whether rates are "stable," simply because it was chosen by Congress to serve as an interim price cap.

[65] 39 U.S.C. § 101(a).

the Postal Service has sufficient resources to ensure its financial integrity. Therefore, any regulatory system can only achieve the objectives if it gives the Postal Service the capability to maintain financial stability: that is, to give the Postal Service the authority to generate revenues from its market-dominant products that, in combination with the revenues generated from its competitive products, is sufficient to enable the Postal Service to sustainably cover its costs, service its liabilities, and undertake appropriate capital investments.

The PAEA also emphasizes the importance of the Postal Service operating in an efficient manner through Objective 1: the system must "maximize incentives to reduce costs and increase efficiency." This reflects the fact that the Postal Service's long-term viability is dependent on its ability to reduce its costs and increase its efficiency.[66] There is no inherent conflict between the achievement of this objective and the achievement of the objectives related to the Postal Service's financial stability. In particular, there is no rational basis to interpret this objective as indicating any intent on the part of Congress to preclude the Postal Service from maintaining financial stability while it is being efficiently managed, taking into account the various requirements and constraints under which the Postal Service operates. Rather, all objectives are appropriately achieved through a regulatory system that gives the Postal Service the capability to maintain financial stability so long as it is being appropriately and efficiently managed.[67]

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[66] S. REP. NO. 108-318, at 8 ("The long-term viability of the Postal Service is addressed by requiring that the Postal Regulatory Commission maximize incentives for the Postal Service to reduce costs and increase efficiency . . . thus maintaining affordable and cost-effective postal services.").

[67] In addition, achievement of the "predictability and stability" objective does not rationally justify a conclusion that the Postal Service should be prevented from having the authority to set rate levels to

1. Two objectives directly require financial stability.

Section 3622 sets forth two objectives that directly address the Postal Service's ability to be meet its statutory obligations in a financially self-sufficient manner. First, the statute requires that the system "assure adequate revenues, including retained earnings, to maintain financial stability." Second, the system must also result in rates and classifications that are "just and reasonable." This second phrase has been consistently interpreted as requiring that the rates charged by a regulated firm be within a "zone of reasonableness," meaning that they are fully compensatory but not excessive.[68] In other words, a regulated firm must be allowed to set rates at levels that maintain its financial integrity,[69] but consumers must be protected against the firm exploiting its market power to earn excessive profits.[70] The Commission has correctly recognized that "just and reasonable" has this meaning, noting that the objective means that "the amount charged for each service is neither excessive to the mailer nor

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maintain financial stability while exercising efficient management. "Predictability" refers to the ability of mailers to "consistently forecast . . . the timing and magnitude" of rate changes, a concept unrelated to the specific rate levels themselves. Order No. 3673 at 5. "Stability," meanwhile, is defined as rates "that do not include sudden or extreme fluctuations," which the Commission proposes to measure by comparing price increases to "objective measures." *Id*. While "stability" seeks rates that do not increase on a year-to-year basis in a "sudden or extreme" fashion, there is no rational basis to read "stable" rates as meaning permanently or persistently "below-cost" rates.

[68] *See, e.g.,* Farmers Union Cent. Exch. v. Fed. Energy Regulatory Comm'n, 734 F.2d 1486, 1502 (D.C. Cir. 1984). *See also* Appendix A at 5 fn.6.

[69] Illinois Bell Tel. Co. v. Fed. Commc'ns Comm'n, 988 F.2d 1254, 1260 (D.C. Cir. 1993) (noting that the "just and reasonable" standard looks, in part, to whether rates are "sufficient to assure confidence in the financial integrity of the enterprise") (citations omitted); Jersey Cent. Power & Light Co. v. Fed. Energy Regulatory Comm'n, 810 F.2d 1168, 1172 (D.C. Cir. 1987) (en banc) ("It is axiomatic that the end result of Commission rate orders must be 'just and reasonable' to both consumers and investors, and that, in achieving this balance, the Commission must consider the impact of its rate orders on the financial integrity of the utility.").

[70] Farmers Union Cent. Exch., 734 F.2d at 1502-04. Furthermore, when evaluating rates under the just and reasonable standard, the cost of service is determined assuming prudent management. Nat. Gas Pipeline Co. of Am. v. Fed. Energy Regulatory Comm'n, 765 F.2d 1155, 1156–57 (D.C. Cir. 1985). In that respect, just and reasonable rates are congruent with the achievement of Objective 1.

threatens the financial integrity of the Postal Service," including in light of "the total compensation" provided by market-dominant products as a whole.[71]

As an initial matter, both of these terms must be applied in a manner that recognizes the specific characteristics of the Postal Service.[72] Although the PAEA made a number of fundamental changes to the regulatory structure governing the Postal Service, it did not change the fact that the Postal Service is a governmental entity that does not need to earn a particular return in order to attract investors. The Postal Service is neither required nor expected to pay a dividend to its only "shareholder," the United States Government.[73] In addition, the Postal Service has guaranteed (albeit strictly limited) access to debt through the Federal Financing Bank (FFB),[74] with no current ability to seek funds from the bond market.[75] However, while the Postal Service need not earn sufficient returns in order to attract equity investors or bondholders, it must be able generate sufficient revenues to ensure the continued achievement of its

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71 Order No. 3673 at 9-10.

72 *Cf.* City of Los Angeles v. U.S. Dep't of Transp., 165 F.3d 972, 978-80 (D.C. Cir. 1999) (analyzing financial integrity under the "just and reasonable" standard with respect to a municipally-owned airport with no stockholders, which are required by statute to "be as self-sustaining as possible"). Furthermore, for private sector firms, an inability to earn compensatory rates due to rate regulation can result in a violation of the Constitution. *See* Southern Bell Tel. & Tel. Co. v. Fed. Commc'ns Comm'n, 781 F.2d 209, 214 (D.C.Cir.1986) (noting that "rates obviously do not fall within a zone of reasonableness if they are so low as to be constitutionally confiscatory"). While this constitutional dimension does not apply to the Postal Service, the statutory standard of "just and reasonable" does, consistent with Objective 8. *Cf.* In re Permian Basin Area Rate Cases, 390 U.S. 747, 770 (1968) (noting "just and reasonable standard of the Natural Gas Act 'coincides' with the applicable constitutional standards").

73 *See, e.g.*, Op. & Rec. Dec., PRC Docket No. R76-1 at 45 ("The only 'owner' of the Service is the United States, which has not invested in it in the hope of receiving dividends out of profits.").

74 39 U.S.C. § 2005 (limiting total outstanding Postal Service obligations to $15 billion, and the net increase of outstanding obligations in any one year to $3 billion).

75 While the statute gives the Postal Service the theoretical ability to issue obligations to the bond market, subject to Treasury approval, 39 U.S.C. § 2006, Treasury as a matter of policy does not allow the Postal Service to do so.

statutory mission and to meet its other legal obligations in a self-sufficient and business-like manner.

The Postal Service retained Evercore to assess the concept of “financial stability” in the specific context of the Postal Service. Evercore’s report, attached as Appendix B, aligns generally with the Commission’s preliminary definition of “financial stability” in Order No. 3673. However, Evercore provides a comprehensive framework through which financial stability can be defined and measured.

Evercore defines financial stability as being the Postal Service’s ability to generate sufficient revenues and retained earnings to cover all of its costs “sustainably.” As it notes, the Postal Service is required to operate “without the significant aid of governmental subsidies or tax revenue,” and therefore must “generat[e] sufficient revenue and cash flow to cover all of its current and future anticipated expenses” through the rates that it charges to users of the mail.[76] This means that the Postal Service must have the ability to cover annual operating expenses (which includes statutorily-mandated payments to fund its pension and retiree health benefits liabilities) and pay “principal and interest on funded debt, as well as other liabilities as they come due.”[77] It also requires that the Postal Service be able to undertake “a prudent level of capital investment (e.g., in real estate, machinery and equipment, etc.) required to maintain the efficiency of and preserve the long-term viability of the Postal Service.” [78]

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[76] Appendix B at 8.

[77] *Id*. at 28, 48.

[78] *Id*. at 28, 49. *See also, e.g.*, Reply Comments of Amazon Fulfillment Services, Inc., PRC Docket No. RM2016-2 (Mar. 25, 2016), at 11 (“To be sure, a firm must cover all of its costs to stay in business over the long run. . . . The firm will survive – indeed, thrive – over the long run as long as its prices in the

Finally, the Postal Service must also have "the ability to support an appropriate balance sheet, including [having] sufficient liquidity to protect against the risks of both normal and cyclical cash flow fluctuations."[79]

Based on this definition, Evercore notes that an understanding of the Postal Service's financial stability should consider three "interdependent categories" that together "offer a comprehensive picture of financial stability": profitability, leverage, and liquidity.[80] Profitability considers the Postal Service's annual revenues compared to expenses.[81] Leverage considers the Postal Service's ability "to service its on-and off-balance-sheet liabilities."[82] In this regard, Evercore notes that the Commission must consider not only the assets and liabilities on the balance sheet, but also the Postal Service's off-balance sheet assets and liabilities (i.e., the assets and liabilities relating to the Postal Service's pension and retiree health benefits (RHB) programs), considering their significance to the Postal Service's financial situation. Finally, liquidity considers whether the Postal Service has "sufficient access to liquidity (defined as cash and /or additional borrowing availability) to withstand cyclicality and unexpected temporary changes in business conditions."[83]

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aggregate cover the firm's total costs. This is an inherent structural characteristic of firms with joint and common costs. These principles are hardly novel; economists have recognized them since the 1840s.").

[79] Appendix B at 10, 28.

[80] *Id*. at 29.

[81] *Id*. at 30.

[82] *Id*.

[83] *Id*. *See also* Order No. 1926 at 116 (citation omitted) (noting that liquidity "is the most important requirement for any business organization," because "[w]ithout the ability to generate sufficient cash from business operations, or to access sufficient debt capacity to invest in the business, an organization cannot continue to operate"); 39 U.S.C. § 2009 (requiring the Postal Service to develop a "business-type budget, or plan of operations, with due allowance given to the need for flexibility, including provision for

Evercore also proposes metrics that can be used by the Postal Service and the Commission to assess the Postal Service's financial condition with respect to each of these pillars. For profitability, Evercore proposes the use of Earnings Before Tax (EBT) margins; for leverage, it proposes the use of Total Debt/Earnings Before Interest, Tax, Depreciation, and Amortization (EBITDA) and Adjusted Total Liabilities/Adjusted Total Assets; and for liquidity, it proposes the use of Theoretical Liquidity Days of Operating Expenses.[84]

Most critically, Evercore notes that, if the Postal Service is to achieve and maintain financial stability, it must generate sustained positive EBT margins over time. Profitability "is critical to consider because it is determinative of an entity's ability to cover its expenses over time."[85] Sustained positive earnings not only ensures that the Postal Service can cover its costs on a yearly basis, but also that it can build sufficient liquidity reserves to withstand adverse changes in business conditions and gradually (through the payment of its statutorily-mandated pension and RHB payments) address the mismatch between the Postal Service's total liabilities and total assets. Hence, sustained profitability, as measured through a positive EBT margin, is the means by which the Postal Service can over time address all aspects of financial stability.[86]

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emergencies and contingencies, in order that the Postal Service may properly carry out its activities as authorized by law").

[84] Appendix B at 35-37 (describing metrics). Evercore also discusses the financial metrics that the Commission proposes to use to measure financial stability in Order No. 3673, and has previously used to assess the Postal Service's financial position. *Id*. at 18-19. While Evercore notes that many of these metrics are relevant, they do not provide a basis to comprehensively assess the Postal Service's financial stability. *Id*.

[85] *Id.* at 19.

[86] Evercore also sets forth what it considers to be appropriate targets if the Postal Service is to move towards financial stability, given the fact that the Postal Service is in a deep financial hole. For instance, Evercore proposes a 6-percent EBT target. *Id*. at 39. To be clear, these targets represent Evercore's

A recognition that financial stability requires the achievement of sustained positive earnings accords with the language of the financial stability objective, which specifically states that the concept of "adequate revenues[ ] includ[es] retained earnings." In other words, Congress intended a system that would give the Postal Service the capability to maintain "long-term financial stability," which necessarily includes the ability to cover its operating costs, pay its debt, make needed capital investments, and fund its post-retirement benefits liabilities.[87] As such, to achieve this objective, the Postal Service must be in a position in which it has the opportunity to generate a sufficient level of revenues from market-dominant products to ensure that it can sustainably cover its costs and generate retained earnings, and thereby also achieve an appropriate level of liquidity and fund its long-term liabilities. This is not to say that any particular level of retained earnings should be guaranteed by the system on an annual basis. However, the system must give the Postal Service the <u>opportunity</u> to achieve appropriate retained earnings so long as it is exercising efficient management.

2. Achieving other objectives is dependent on financial stability.

The achievement of several other objectives is also dependent on the Postal Service's ability to maintain its financial stability, and hence sustainably cover its costs over the long-term.

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recommendations, and should not be interpreted as an indication that the <u>Postal Service</u> has determined that that those are necessarily the right targets moving forward.

[87] H.R. REP. NO. 109-66, pt. 1, at 71 (explaining that "long-term viability" is achieved though "further reducing the unfunded liability for retiree health benefits" as well as "debt repayment").

First, Objective 3 requires that the ratemaking system enable the Postal Service to "maintain high quality service standards established under section 3691." The Commission proposes interpreting this objective to mean that any system must allow the Postal Service "to consistently achieve, for each class of mail, stated days to delivery at a desired target rate."[88] While this proposed interpretation is eminently reasonable, it bears emphasizing that the Postal Service's ability to consistently perform to its service standards fundamentally depends on having the necessary financial resources, such as the capital to invest in needed infrastructure improvements and the cash to fund maintenance, train employees, and the like. In this regard, it is considerably more difficult to maintain quality service over an extended period of time if the Postal Service is in a position of financial distress, not only because of a lack of resources, but also because it might lead the Postal Service to undertake operational initiatives to save costs in a manner that proves not to be conducive to maintaining high-quality service.

The Commission has previously recognized that the maintenance of high-quality service performance is dependent on the Postal Service's financial position. In particular, in assessing whether an exigent increase due to the volume declines resulting from the Great Recession was "necessary" for purposes of the current exigency clause, the Commission recognized that a poor financial position inhibits the Postal Service's ability "to both maintain the Nation's needed postal services and

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[88] Order No. 3673 at 5. Therefore, the Commission appropriately recognizes that this objective is not fulfilled whenever the Postal Service has literally "maintain[ed] high quality service standards established under section 3691," in terms of having simply established high-quality service standards. Rather, the objective addresses the Postal Service's ability to actually achieve those standards.

continue the development of those services."[89] The Commission noted that adequate liquidity is needed to finance capital outlays, which are essential if the Postal Service is to continue providing high-quality service, and which is inhibited in circumstances of financial instability:

> The consequences of continued low levels of liquidity and related low levels of capital investment are significant to the entire postal system. If the Postal Service is unable to repair, maintain, and replace its fleet of delivery vehicles, it could very quickly lose its ability to meet the delivery requirements of the [universal service obligation (USO)]. Similarly, if important pieces of machinery are unable to be repaired and replaced, service performance and the Nation's "ready access" to postal services will be substantially impacted.
>
> The proposed price increase can only be approved if it is necessary to enable the Postal Service to maintain and continue the development of the Nation's needed postal services. The Postal Service's current liquidity levels severely jeopardize its ability to make the investments necessary to maintain universal service and continue the development of the Nation's needed level of postal services.[90]

Second, a lack of financial stability can also inhibit the Postal Service's ability to ensure the efficiency of its operations, contrary to the principles of Objective 1. The Commission has noted that a limited ability to make capital investments due to financial instability can "hinder[ ] growth and productivity enhancements in key infrastructure assets required for primary postal operations," and that "[c]apital investments in physical

[89] Order No. 1926 at 119-22. Therefore, while the Commission in an earlier order drew a distinction between ensuring the financial stability of the Postal Service and the provision by the Postal Service of quality service, *see* Order No. 547 at 17, it later recognized that the two ultimately go hand-in-hand.

[90] Order No. 1926 at 120-21. The Commission also noted that increases in capital outlays will be necessary in upcoming years in order to ensure the continuation of universal service: "capital outlays <u>must be increased</u> in order for the Postal Service to maintain and continue to develop the Nation's needed postal services." *Id*. at 120 (emphasis added).

resources are necessary to increase and maintain productivity."[91] The Commission made this same point prior to the PAEA:

> Another reason for avoiding chronic operating deficits is their tendency to lead to inefficient operations. The need to avoid exacerbating an already poor financial situation may cause the underfunding of needed activities such as maintenance, new programs, and capital expenditures. Chronic deficits tend to eliminate the operating flexibility that a well-run business must have. As the *Report of the President's Commission on Postal Reorganization* stated, "[t]he [Postal] corporation should be self-supporting because: subjecting a business activity to deficit financing stifles management initiatives and practically guarantees inefficient operation. . ." *Toward Postal Excellence* at 57. In the event that volume growth stops or slows precipitously, large negative equity may mean that the Service lacks the financial resources necessary to adjust to its changed circumstances.[92]

Third, a lack of financial stability can also inhibit the Postal Service's ability to have the resources needed to protect the security of the mail, and therefore is contrary to the achievement of Objective 7. The Commission has proposed to define the achievement of this objective as requiring a ratemaking system that "encourages methods of safeguarding the mail system from illegal or dangerous use, or terrorism," and recognizes that achieving this goal requires that there be "available funds" both to finance the necessary safeguards and to respond to specific threats.[93]

Finally, an inability of the Postal Service to set rates at levels that ensure its financial stability is also inconsistent with the "pricing flexibility" objective (Objective 4).

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[91] *See, e.g.*, Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2014 (2015) [hereinafter "FY2014 Financial Analysis Report"], at 23-24. The General Accountability Office (GAO) has also noted that "[e]ffective capital investments can improve productivity, provide much-needed cost savings, and prevent larger, more costly expenses in the future." GAO, GAO-14-155, U.S. Postal Service: Actions Needed to Strengthen the Capital Investment Process (2014), at 2.

[92] Op. & Rec. Dec., PRC Docket No. R94-1 (Nov. 30 1994), at ¶ 2090 (internal quotation marks and alterations in original).

[93] Order No. 3673 at 8-9.

The Commission proposes to define that objective as "allowing for the Postal Service to exercise its discretion to set prices, the price structure, and the price schedule for market-dominant products, subject to the other requirements under the law."[94] A critical part of such "discretion" is whether the Postal Service has the ability to set overall rate levels that enable financial stability.

3. A core obligation of the Postal Service is to pursue cost reductions and efficiency improvements.

In order to achieve the objectives discussed above, any regulatory system must give the Postal Service the opportunity to generate sufficient revenues from its market-dominant products so that it can, along with the revenues provided by its competitive products, sustainably cover its costs, service its liabilities, and have appropriate liquidity reserves. At the same time, in considering the Postal Service's revenue needs, the PAEA requires the achievement of another objective: that the system "maximize incentives to reduce costs and increase efficiency." This objective reflects Congress's desire to ensure that, unlike the PRA regime, the ratemaking system under the PAEA provides clear legal incentives for the Postal Service to reduce costs and increase efficiency. There is no inherent conflict between the achievement of this objective, when properly interpreted, and the achievement of the objectives related to the Postal Service's financial stability: rather, the statute requires that the system give the Postal Service the authority to set rates to sustainably cover its costs so long as the Postal

[94] *Id.* at 6.

Service is fulfilling its fundamental duty to reduce costs and increase efficiencies within the constraints of the law.[95]

a. The Commission should use a range of measures when measuring the achievement of this objective.

The Commission notes that achieving Objective 1 requires a system that ensures the Postal Service has "maximum incentives" to reduce operating costs and increase "operational efficiency."[96] These considerations are related, in that reductions in costs can help to drive efficiency gains. However, not every initiative that reduces costs will be materially reflected in the various efficiency metrics; for instance, the labor component of TFP is predicated on employee complement and workhours, as opposed to the wages and benefits paid to employees. Hence, a reduction in employee wages, such as through the imposition of the two-tier wage schedule, does not have a material impact on TFP. In assessing the achievement of this objective, it is therefore critical that the Commission keep in mind the factors that affect the calculation of those metrics that it indicates that it may use used to assess the Postal Service's cost reduction efforts and operational efficiency. Given that no single metric captures everything that the Postal Service may be doing to reduce costs and increase efficiency, the Commission should use a range of measures when assessing the achievement of this objective.[97]

[95] *Cf.* Order No. 1926 at 175 (noting that the Postal Service has an "obligation to respond to revenue losses by reducing costs or improving efficiencies," which is "a continuing obligation . . . at the heart of the PAEA").

[96] Order No. 3673 at 4. The Commission also notes that Objective 1 incorporates pricing efficiency, which is discussed below. *Id*.

[97] *See also* Ofcom, Review of the Regulation of Royal Mail, Annex 5, at ¶¶ A5.60 et seq. (May 25, 2016) (noting the importance of considering a variety of data and metric when assessing efficiency).

In Appendix D, Christensen Associates provides a discussion of how TFP is calculated, and the principles that should be considered when using to consider Postal Service efficiency trends. TFP is a comprehensive measure of Postal Service productivity because it considers both workload and resource usage. However, Christensen notes that (1) TFP is a "top-down measure of operational efficiency," which "does not provide a 'benchmark' that specifies the degree to which TFP can increase if best practices are adopted" in any given year; and (2) there will be variation in TFP results on a year-to-year basis as the conditions facing a firm change.[98] Therefore, Christensen notes that "[w]hen using TFP as an evaluation tool of management, it is important to look at TFP trends over several years rather than isolated annual TFP results."[99] This is consistent with the Commission's recognition in Order No. 3673 that efficiency should be assessed through "trend analysis" of TFP and other potential metrics.[100]

Moreover, when considering the Postal Service's cost reduction efforts, it is important to comprehensively assess the Postal Service's actual initiatives to reduce costs, and future operational plans, without focusing simply on metrics such as unit operating costs or controllable costs. How those metrics vary over time is subject to a large number of factors that are outside of the Postal Service's control. For instance, "unit operating costs" will be affected by the Postal Service's declining economies of density. In addition, while "controllable costs" is a term that has been used by the

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[98] Appendix D at 1.

[99] *Id.* at 6 & fn.15. Christensen notes that one expert on TFP suggests that TFP trends over a 5- to 10-year period be used when assessing management performance. *Id*.

[100] Order No. 3673 at 4.

Postal Service in recent years to highlight the impact of certain items that affect net income for which the Postal Service has absolutely no control, it is not the case that the items within "controllable income" are therefore fully within the Postal Service's control (jn fact, as discussed below, many significant elements within the Postal Service's "controllable costs" are not within its direct control, such as its normal cost payments under the Federal Employees Retirement System (FERS) and the costs that result from collective bargaining). Moreover, when attempting comparisons of Postal Service costs across time, it is essential that the Commission take into account how factors outside of the Postal Service's control may have changed over the relevant time periods.[101]

b. This objective requires that the Postal Service be focused on continuous improvement regarding cost reductions and efficiency.

By focusing on whether the Postal Service has "maximum incentives to reduce costs and increase efficiency," the plain language of this objective also necessarily contemplates that opportunities for further cost reductions and efficiency improvements will exist. This reflects reality: like any organization, particularly one the size of the Postal Service, reducing costs and enhancing efficiency is a process of continuous improvement.[102] Therefore, whether this objective is being achieved must be measured

[101] It is also necessary for the Commission to make sure that it is conducting a true "apples-to-apples" comparison. For instance, in its FY2012 Annual Report, the Commission used operating expenses to indicate that there was a huge difference between the Postal Service's cost reduction and efficiency efforts after the PAEA, as compared to prior to the PAEA. Postal Regulatory Comm'n, Annual Report to the President and Congress, Fiscal Year 2012 (Jan. 1, 2013), at 16. However, the chart used by the Commission excluded a significant expense from the post-PAEA line (the RHB prefunding payments), while including significant CSRS-related expenses in the pre-PAEA line that were replaced by the RHB prefunding stream.

[102] *See, e.g.*, *The Impact of the Economic Crisis on the U.S. Postal Service: Hearing Before the Subcomm. on Fed. Fin. Mgmt., Gov't Info., Fed. Servs., and Int'l Sec. of the S. Comm. on Homeland Sec. and Govtl. Affairs*, 111th Cong. 35 (2009) (statement of Dan G. Blair, Chairman, Postal Regulatory Commission) ("Can the Postal Service do more? Of course it can do more. Any organization can do more. But I do know that it is focused on addressing the issues involved with the declining mail.")

by whether the Postal Service has the appropriate incentives to reduce costs and improve efficiency, as evidenced by the Postal Service's initiatives to achieve those goals both retrospectively and prospectively. Indeed, as the Commission has previously noted, the PAEA's purpose was to ensure that the Postal Service focuses on adjusting "over time" to volume declines, and that "[t]he process of right-sizing the Postal Service's network to handle projected lower volumes in an efficient manner is a continuing process."[103] The Commission should reject any arguments that the Postal Service should be denied the capability to achieve and maintain financial stability simply because further opportunities for cost reductions and efficiency gains exist. This is particularly true because, as noted above, financial instability can hinder the Postal Service's ability to successfully reduce costs and increase efficiency.

Moreover, in assessing the Postal Service's management practices, the Commission should provide an appropriate degree of discretion to the Postal Service's exercise of business judgment. As Chairman Taub noted in testimony to Congress, the Postal Service is the operator, while the Commission is the regulator.[104] Therefore, it is the role of the Postal Service to weigh the risks and expected payoff of various courses of management action and to choose reasonably among them. While the Commission is certainly authorized to assess the prudence of the Postal Service's management

[103] Order No. 1926 at 131, 178. The Commission therefore rejected arguments that the exigent increase should be denied simply because further cost savings opportunities existed. *Id.* ("Even if the Commission found, as the commenters argue, that the Postal Service did not take every available step to cut costs before filing its Request, that fact alone would not be a sufficient basis to deny the Request. . . . Although commenters have identified additional areas in which cost savings are available, as the Commission found in Order No. 547, '[w]ith respect to Postal Service efforts to cut costs, data suggest that it is making strides over time to cope with volume declines consistent with how the PAEA was intended to function.'").

[104] *Laying Out the Reality of the United States Postal Service: Hearing Before the S. Comm. on Homeland Sec. & Govtl. Affairs*, 114th Cong. (2016) (written testimony of Robert G. Taub, Acting Chairman, Postal Regulatory Commission), at 2.

choices in the exercise of its regulatory authority, the Commission should recognize that there will always be a range of possible business decisions that fit within the bounds of appropriate management. That the Commission or another party might have made a different decision is immaterial to the question of whether the Postal Service's actions were within the scope of prudent management practices.

At the same time, this division of responsibility between the Postal Service and the Commission does not mean that the Commission can rationally apply this objective without considering the level of cost reductions and efficiency gains that are practicably achievable by the Postal Service on an ongoing basis. The Commission should therefore reject arguments that seek to predicate the application of this objective on superficial generalizations that the Postal Service must simply "become more efficient" in order to operate successfully within the existing system (or any alternative system the Commission considers). Rather, in balancing this objective against the others, the Commission must consider the actual costs being incurred by the Postal Service, and the Postal Service's practical ability to reduce those costs moving forward consistent with maintaining adequate levels of service and meeting its other statutory obligations within the "unique framework" under which it operates.[105]

c. Interpreting the efficiency objective requires a consideration of the factors affecting the Postal Service's managerial flexibility.

In this regard, the Commission appropriately recognizes that in applying Objective 1 it is necessary to recognize the "statutory constraints" under which the Postal Service operates. The ratemaking system under Section 3622 exists within a

[105] Order No. 1926 at 127 (noting that "the unique framework within which the Postal Service must operate is a relevant consideration in determining what constitutes best practices" for Postal Service management.").

broader statutory structure which, as discussed further below, ultimately places many of the most significant elements of Postal Service costs outside of its full control. Given that Congress maintained this structure in the PAEA, while at the same time maintaining the fundamental policy that the Postal Service be self-sufficient, there is no rational basis to conclude that Congress intended that Objective 1 be interpreted in a way that fails to recognize the statutory environment under which the Postal Service operates. Rather, Objective 1 must be read in the context of the statute as a whole,[106] meaning that when assessing the Postal Service's efforts to reduce costs and increase efficiency, those costs that are the result of the Postal Service's statutory structure are inherently consistent with the efficient management of the Postal Service.[107]

Indeed, the language of Objective 1 makes this interpretation clear, because it addresses the need for the ratemaking system to supply "maximum incentives" for the Postal Service to reduce costs and increase efficiency. By focusing on "incenting" the Postal Service, it is clear that Congress did not intend the objective to be interpreted as calling into question the need for the Postal Service to cover those costs that are ultimately outside of its control: such costs cannot be reduced by more aggressive Postal Service management, no matter how strong the Postal Service's incentives are.[108] Therefore, the fact that the Postal Service is incurring costs that are outside its control cannot be considered a basis to conclude that the Postal Service is being

[106] *See, e.g.*, *Utility Air Regulatory Group,* 134 S. Ct. at 2441 (recounting "the fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme"); Food & Drug Admin. v. Brown & Williamson Tobacco Corp., 529 US 120, 132-33 (2000).

[107] Pub. Serv. Co. of Indiana v. Interstate Commerce Comm'n, 749 F.2d 753, 767 (D.C. Cir. 1984) (noting that "factors beyond the control" of the regulated entity do not demonstrate inefficiency).

[108] *Id.*

inefficiently managed, regardless of whether a party might characterize those costs as being "efficient" in an abstract sense.

The Commission's recognition of the need to consider "statutory constraints" when applying Objective 1 also accords with how it has previously assessed the operational efficiency of the Postal Service through the concept of "honest, efficient, and economical management" (HEEM). This specific standard is reflected not only in the current exigency clause – the specific context in which the Commission has considered it before – but also in Section 404(b), which states:

> Postal rates and fees shall be reasonable and equitable and sufficient to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.

While the Commission may not consider this provision to be directly on point,[109] it is at least a useful reference point by which to assess how to apply the objectives in a balanced way, considering that it incorporates the concepts of operational efficiency, financial stability, and the provision of quality service into a coherent policy statement.[110]

In its prior assessments of the Postal Service's management under the HEEM standard, the Commission has recognized that it must consider "the parameters under which the Postal Service operates," which "include legal obligations, such as the universal service obligation, the 6-day delivery requirement, binding contractual

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[109] *See* Order No. 1926 at 33 (distinguishing Section 404(b), which "authorizes the Postal Service to exercise certain corporate powers," from "a regulatory provision intended to ensure that legal standards and the congressional intent they embody are properly administered").

[110] At the very least, the provision can be taken into account pursuant to Factor 14.

obligations such as labor agreements, and such other limitations upon, or prerogatives enjoyed by, the Postal Service."[111] The same constraints bear on the Commission's application of Objective 1.

d. The Commission cannot use its regulatory authority to encourage or incent Congress to change the law.

In a broader policy sense, of course, the costs that the Postal Service's statutory structure imposes are excessive in a variety of respects. For instance, the Postal Service believes that its post-retirement benefits costs are too high, and has therefore urged that Congress address certain of those costs through postal reform legislation. The Commission has also communicated its belief that various statutory reforms should be enacted by Congress.[112] Other parties may have their own views that certain elements of the statutory structure are not appropriate policy.

Moreover, Congress is currently considering a bill that would incorporate many legislative reforms supported by the Postal Service and a number of postal stakeholders.[113] The Postal Service will continue to urge Congress to enact comprehensive postal reform legislation. As noted in prior testimony to Congress, the optimal way to address the Postal Service's current financial condition would be through a combination of regulatory and legislative reform (along with continued efforts by the Postal Service to cut costs and increase efficiency). However, the existence of this pending legislation does not impact the Commission's conduct of this review.

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[111] Order 1926 at 34. *See also id.* at 127.

[112] *See generally* Postal Regulatory Comm'n, Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006 (2016); Postal Regulatory Comm'n, Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006 (2011).

[113] H.R. 756, 115th Cong. (2017).

In applying the objectives, the Commission must apply the statute as it is, not as it might be if hypothetical postal reform legislation were enacted into law. As the Commission has noted on a number of occasions, because "the legislative process is uncertain, and the results of pending legislation are highly speculative," it does not take pending legislation into account when conducting its proceedings under the terms of existing law.[114] Therefore, it would be improper for the Commission to assess the achievement of an objective by reference to potential changes to the law. The hypothetical future passage of legislation is also certainly no basis to delay any aspect of this review, such as to hold off on any changes to the system in order to give Congress time to enact legislation. Ultimately, if legislation is enacted either during this proceeding, or after this proceeding, the Commission can assess its impact then.[115]

In any event, as discussed below in Section IV, even if H.R. 756 were enacted in its current form, that action by Congress would not logically impact the outcome of this review. Enactment of that legislation would not alter the fact that the current system has not, and going forward will not, achieve the objectives. Therefore, while the legislation would enact critically important reforms, it does not obviate the need for the replacement of the current price cap system. Additionally, enactment of that legislation

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[114] Order No. 1926 at 42 fn.27 (citing Order No. 937, Order Denying Motion to Stay and Establishing Further Procedures, PRC Docket No. R2010-4R (Oct. 31, 2011) at 7-8). *See also* Presiding Officer's Ruling No. R2005-1/84, Presiding Officer's Ruling Denying the Office of the Consumer Advocate Motion to Compel Responses to Interrogatories OCA/USPS-196-207, PRC Docket No. R2005-1 (Sept. 21, 2005), at 4 (noting that the "Commission and participants must act in accordance with the law as it is currently written, not speculate upon possible Congressional intervention into that process."). Indeed, "allowing agencies to ignore statutory mandates and prohibitions based on agency speculation about future congressional action [ ] would gravely upset the balance of powers between the Branches and represent a major and unwarranted expansion of the Executive's power at the expense of Congress." In re Aiken County, 725 F.3d 255, 260 (D.C. Cir. 2013).

[115] *See* Order No. 937 at 7-8. As noted above, now that 10 years has passed since the enactment of the PAEA, Section 3622(d)(3) authorizes the Commission to assess the regulatory system at such times as it considers appropriate.

would not alter the reasons why a regulatory monitoring approach is the best means of achieving the objectives moving forward.

Furthermore, it would be impermissible for the Commission to conclude that it can appropriately disregard costs that are dictated by, or result from, the application of the statute, simply because it believes those costs to be excessive. If the Commission took the position that the regulatory system can fail to enable the Postal Service to cover such costs, the Commission would essentially be dictating to Congress what postal policy should be: either Congress must change the statute to eliminate those costs, or it must accept that those costs will not be covered by postal ratepayers (which would require it to abandon its policy that the Postal Service be self-sufficient). However, as the Commission has recognized, its role as an agency administering the ratemaking provisions of the statute is not "to provide incentives to Congress, but rather to apply the law in a manner that is consistent with congressional intent."[116] In other words, the Commission recognizes that, like any other agency, it must effectuate Congressional intent: "[d]isagreeing with Congress's expressly codified policy choices isn't a luxury administrative agencies enjoy."[117]

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[116] Order No. 864, Order Resolving Issues on Remand, PRC Docket No. R2010-4R (Sept. 20, 2011), at 42.

[117] Cent. United Life Ins. Co. v. Burwell, 827 F.3d 70, 73 (D.C. Cir. 2016). Indeed, at several points in the PAEA, Congress authorized the Commission to recommend possible legislative changes to Congress, based on the Commission's assessment of what would be appropriate postal policy. Pub. L. No. 109-435, 120 Stat. 3198, § 701 (Dec. 20, 2006) (requiring the Commission to submit a report to the President and Congress every 5 years assessing how well the PAEA has operated and recommending measures to improve the effectiveness and efficiency of postal laws); *id*. § 702 (calling for a report on the universal service obligation and the postal monopolies to be submitted by the Commission to Congress no later than two years after the PAEA's enactment).

Therefore, it is Congress's prerogative to dictate the Postal Service's statutory structure, and it is the Commission's duty under Section 3622(d)(3) to apply the objectives in a manner consistent with that structure. Objective 1 cannot be reasonably interpreted to mean that the Postal Service must be denied the opportunity to achieve financial stability unless and until Congress revamps the statutory and political environment in which the Postal Service operates. Nor can the Commission demand that the Postal Service disregard its current obligations as a Federal entity.[118]

e. The Postal Service has limited control over its labor costs.

Among the costs that are incurred as a result of policy decisions by Congress, and which are therefore *per se* consistent with the "efficient" operation of the Postal Service as a statutory matter, are those costs that result from the fact that (1) postal employees and annuitants participate in federal benefits programs pursuant to statute, and (2) wages and other terms and conditions of employment are set through collective bargaining which, in the case of impasse, is resolved through binding arbitration.[119] Therefore, any system that achieves the objectives – by giving the Postal Service the

[118] In addition, the Postal Service's statutory structure means that this objective cannot be measured through superficial comparisons to the private sector. The Postal Service operates as part of the Federal government, pursuant to a legal and policy environment that sets forth obligations, and constrains management discretion, in a manner that contrasts sharply with the environment in which private sector firms operate. Therefore, in assessing the Postal Service's achievement of this objective, it is critical that the Commission reject any superficial comparisons any party may make to how the Postal Service has operated, as compared to the private sector. *See* Pub. Serv. Co. of Indiana v. Interstate Commerce Comm'n, 749 F.2d 753, 768-69 (D.C. Cir. 1984) (noting that it is "absurd" to compare the efficiency of one entity to another entity "without considering the differences, if any, between the two [entities'] operating characteristics," and that it therefore "complete folly" to superficially compare one entity to another entity that was "not comparable"). In any event, as demonstrated in Section IV.A.5.a below, the Postal Service has increased efficiency and reduced costs at levels consistent with or exceeding most private sector entities.

[119] 39 U.S.C. § 1207. As an employer subject to the National Labor Relations Act, the Postal Service cannot unilaterally modify wages, hours, working conditions, or other mandatory subjects for bargaining. *E.g.*, Nat'l Labor Relations Bd. v. Katz, 369 U.S. 736 (1962).

capability to sustainably cover those costs that are being incurred through efficient management – must give the Postal Service the authority to cover these costs.

i. *Benefits costs*

By statute, postal employees participate in the federal worker's compensation, pension, and health benefits programs.[120] The Postal Service is also required by statute to make a number of payments to finance its required participation in these programs. All of these health benefits and pension payments are required by law and calculated either by the Office of Personnel Management (OPM) or the Department of Labor.

As discussed in section IV below, these payments constitute a significant portion of the Postal Service's annual expenditures, which Congress clearly intended that the ratemaking system enable the Postal Service to cover. Indeed, since the PRA Congress has repeatedly enacted legislation to transfer the financing of postal employee and postal annuitant benefits to postal ratepayers rather than taxpayers, consistent with the goal of Postal Service self-sufficiency.[121] The PAEA itself introduced the prefunding of RHB to ensure this goal was achieved. Failure to make one or more of these payments moving forward would mean that the Postal Service is not setting sufficient money aside to cover the estimated benefits liabilities, which therefore

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[120] 39 U.S.C. § 1005. While the statute enables the Postal Service to substitute different programs in some instances, *id.* § 1005(f), doing so requires adherence to the collective bargaining process, and hence is subject to the constraints discussed below.

[121] *See, e.g.*, H.R. CONF. REP. NO. 101-964, 1990 U.S.C.C.A.N. 2374, 2682-2686 (1990) (describing transfer by the Omnibus Budget Reconciliation Act of 1990 of pension and health benefits funding obligations from the Treasury to the Postal Service, and noting that those new obligations would be funded by postal ratepayers).

exacerbates the risk that taxpayers would eventually be required to finance those benefits when they come due.

While, as discussed above, it would certainly be preferable for Congress to enact reforms that reduce the Postal Service's RHB and pension liabilities, and hence the size of the necessary payments, this does not give the Commission a basis to disregard them for purposes of applying the objectives. Prior to the PAEA, the Commission recognized that Postal Service rates had to cover the costs that resulted from Public Law No. 108-18 (including the escrow), even though there was widespread consensus that those payments should be eliminated by Congress, and Congress was in fact actively considering legislation to do so.[122] Nothing justifies a different approach now.

Furthermore, the Commission also cannot disregard these payments simply because the Postal Service has, under the current system, defaulted on the past six RHB prefunding payments (totaling $33.9 billion), without any legal consequences. The Postal Service defaulted on those payments because it lacked the ability to simultaneously fulfill all of its various statutory obligations, given the constraints of current law (including the CPI-U cap). In these circumstances, the Board of Governors determined that it was appropriate to prioritize the achievement of the Postal Service's mission to provide postal services adapted to the needs of the United States – which the statute specifies as its "basic function" – over fulfilling its statutory RHB prefunding obligations.[123] Therefore, the defaults were a necessary action to account for

[122] Op. & Rec. Dec., PRC Docket No. R2005, at 32-36.

[123] Specifically, the Board has determined that, in deciding how to prioritize the expenditure of the Postal Service's funds consistent with the "public interest," it is most appropriate to ensure that the Postal Service has the ability to continue achieving "its basic function" of providing prompt, reliable, and efficient postal services, over meeting certain other statutory obligations. 39 U.S.C. § 101(a); *see also id.* §§ 403(a), 404(b).

circumstances outside of the Postal Service's control. They did not constitute a determination by the Postal Service that the payments, which are mandated by statute, were unimportant, nor could the Postal Service (or the Commission) permissibly make such a determination. Rather, as discussed in section IV.A below, the fact that the Postal Service has been forced to default on these statutory obligations is evidence that the current system has failed to achieve the objectives, not that those payments need not be made paid by the Postal Service.[124]

ii. *Costs incurred through collective bargaining/interest arbitration*

For those wages, benefits, and other terms and conditions of employment that are mandatory subjects of bargaining under the statute, binding interest arbitration occurs when there is impasse between the Postal Service and a bargaining representative. Therefore, rather than allowing disputes to be determined on the basis of the parties' relative economic power, this method effectively leaves dispute resolution to a third party, whose decision on matters such as wage comparability is binding.

Therefore, the costs that result from the collective bargaining process are not within the Postal Service's direct control. The fact that binding arbitration will occur if impasse is reached is a "compromise-forcing mechanism" that affects the entire bargaining process.[125] In particular, the existence of binding arbitration naturally limits

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[124] In addition, while Congress has not indicated that it believes the Postal Service's actions to default have been improper, that fact does not mean those payments are no longer mandated by law. Congress cannot amend a statute by inaction, meaning payments required by the Postal Service that it has been forced to default on are not eliminated simply because Congress has not taken action to force the payments.

[125] *See* Dep't of Transp. v. Ass'n of Am. R.R., __ U.S. __, 135 S. Ct.1225, 1236 (2015) (Alito, J., concurring); Ass'n of Am. R.R. v. Dep't of Transp., 821 F.3d 19, 37 fn.6 (D.C. Cir. 2016).

the Postal Service's discretion during the bargaining process, because it must decide whether any negotiated agreement is likely to be better than what it could practicably seek to achieve through arbitration. Thus, even when the Postal Service reaches a negotiated agreement (meaning binding arbitration is avoided), the terms of that agreement are inherently impacted by the very existence of the arbitration process.[126]

Indeed, the binding arbitration process generally tends to be an incremental process: arbitrators generally have tended to favor the precedent of prior arbitral awards (or the parties' prior agreements reached under the color of arbitration). Ultimately, this means that the existence of a persistent compensation premium for many employees is a structural consequence of the arbitration process, not a failure on the part of the Postal Service: while arbitrators have often noted the existence of a wage premium, that premium nevertheless persists because the arbitration awards have failed to effectively address it.

The Commission has never sought to use its regulatory authority to attempt to influence the outcome of the collective bargaining process, and it would be clearly impermissible for it to begin now. Recognizing the limitations of the interest arbitration process, the President's Commission proposed what it saw as a solution: giving the Commission the authority to determine wage and benefit comparability.[127] However, Congress firmly rejected this suggestion. Instead, the PAEA expressly <u>precludes</u> the Commission from taking any action pursuant to authority granted to it by that Act that interferes with the collective bargaining process. Specifically, the PAEA states:

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[126] *See Ass'n of Am. R.R.*, 821 F.3d at 37 n.6.

[127] President's Commission Report at 69, 118-119.

> Nothing in this Act shall restrict, expand, or otherwise affect any of the rights, privileges, or benefits of either employees of or labor organizations representing employees of the United States Postal Service under chapter 12 of title 39, United States Code, the National Labor Relations Act, any handbook or manual affecting employee labor relations within the United States Postal Service, or any collective bargaining agreement.").[128]

The reference to "nothing in this Act" clearly includes Section 3622(d)(3). Hence, the Commission cannot, based on its determination that the collective bargaining process has not resulted in outcomes that it (or certain stakeholders) may prefer, seek to utilize its regulatory authority to attempt to affect those outcomes moving forward. For instance, the Commission must analyze the Postal Service's revenue needs under Objective 5 based on what the costs that result from collective bargaining actually are, and not on what it considers to be an appropriate level under the relevant statutory standards in Chapters 10 and 12. The statute clearly states that the application of those provisions occurs through the collective bargaining process, and therefore places such matters outside of the Commission's purview.

The legislative history of Section 505(b) of the PAEA further demonstrates that the Commission must accept the outcomes of collective bargaining, for purposes of exercising its authority over the market-dominant ratemaking system. The provision originated in the early House bills that would have established a detailed price cap framework. In those bills, the provision governed the Commission's exercise of its authority to establish an adjustment factor for the price cap based on a consideration of whether the revenues allowed by the inflation index would enable the Postal Service to cover its anticipated costs, including its "wages" and "benefits" costs, through efficient

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[128] PAEA, § 505(b), 120 Stat. 3198, 3236 (2006) (emphasis added).

management.[129] Its original purpose was thus focused precisely on ensuring that the Commission would not use its regulatory authority over the market-dominant regulatory system to seek to influence or "otherwise affect" the collective bargaining process by establishing the adjustment factor in a way that would not take Postal Service labor costs fully into account. The fact that Congress subsequently expanded the scope of the provision, by moving it to a separate section and stating that it applied to the entirety of the PAEA (as opposed to simply the market-dominant regulatory provisions of the statute), certainly encompasses this original purpose as well.[130]

Therefore, for purposes of assessing the achievement the objectives, the Commission must take labor costs resulting from the collective bargaining agreements as they are, and not how it or any other party might wish them to be. This is true regardless of whether those costs are the subject of a negotiated agreement or an

[129] H.R. 22, 106th Cong. § 201 (setting forth the following provision: "Postal Regulatory Commission Not To Interfere With Collective Bargaining.--It is the sense of the Congress that nothing in this section should restrict, expand, or otherwise affect any of the rights, privileges, or benefits of either employees of the United States Postal Service, or labor organizations representing employees of the United States Postal Service, under chapter 12 of this title, the National Labor Relations Act, any handbook or manual affecting employee labor relations within the United States Postal Service, or any collective bargaining agreement."). In considering Postal Service wage and benefits costs for calculating the adjustment factor, the Commission would have had to act "consistent with" this limitation.

[130] Moreover, recognizing the limitations imposed on the Commission by Section 505(b) of the PAEA does not mean that the initial price cap system established by Congress also violates Section 505(b), such that the cap would have to be interpreted as being surplusage. The relationship between Section 505(b) and the initial price cap enacted by Congress presents a fundamentally different question than whether and how Section 505(b) constrains the Commission's exercise of regulatory discretion under Section 3622. Opposition of the United States Postal Service to Motion for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 10, 2017), at 13 & fn.30. Furthermore, the price cap established by Congress does not in any way predicate allowed rate levels for market-dominant products on determinations of whether existing compensation levels, established through the collective bargaining process, are appropriate under Chapters 10 and 12. As such, there is no inherent conflict between Section 505(b) and the CPI-U price cap. By contrast, arguments that the Commission should take into account whether a wage premium exists when assessing the achievement of the objectives would be seeking to directly tie appropriate rate levels to the outcome of collective bargaining: the purpose of such an approach would be to state that rates cannot be used to recover costs that the Commission believes to be inconsistent with Chapters 10 and 12, even though these costs are the result of the collective bargaining process. Such an approach by the Commission would clearly violate Section 505(b).

arbitration decision, since the fact that the latter can occur if the parties do not reach an agreement necessary affects the outcome of the former. The Commission cannot apply Section 3622 in a way that explicitly or implicitly treats those costs as being improper.[131]

iii. *Provision of universal postal services*

Another critical factor underlying Postal Service costs, and hence in considering the revenue needs of the Postal Service through the exercise of efficient management, concerns the service levels provided by the Postal Service. In interpreting and applying the objectives with respect to this issue, the Commission must also take into account the statutory structure regarding the provision of universal service. Objective 3 requires the system to "maintain high-quality service standards established under section 3691." More generally, the Postal Service's "basic function" is to provide prompt, reliable, and efficient universal postal services adapted to the needs of the United States.[132] Assessing the achievement of Objective 3 (which, as noted above, is inextricably linked to the achievement of Objectives 5 and 8) in relation to Objective 1 requires a consideration of what postal services are appropriate to meet the postal needs of the

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[131] For the reasons discussed more fully below, the Postal Service has strong incentives to pursue cost savings through the bargaining process, considering its critical need to reduce costs in order to survive in the current marketplace. The Commission should recognize this fact, and also reject any arguments that the Postal Service is acting improperly by not undertaking a bargaining strategy that is as confrontational as a party might prefer. Indeed, particularly given the labor-intensive nature of the Postal Service, constructive labor relations are critical to effective and efficient postal operations, and there is no rational basis to conclude that Congress intended any provision of Section 3622 to require the Postal Service to have an adversarial relationship. *Cf. The Postal Service: Planning for the 21st Century: Hearing Before the H. Subcomm. on Fed. Workforce, Postal Serv., and D.C. of the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 138 (2007) (statement of Jerry Cerasale, Senior Vice President, Direct Marking Association, Inc.) ("One of the things for an efficient Postal Service and how it works, however, is that the labor management climate within the Postal Service, the Postal Service has to work and work well, and that means management and their employees working together and working well. That is part of an efficient Postal Service as well.").

[132] 39 U.S.C. § 101(a). *See also* Order No. 1926 at 115 ("The Postal Service's universal service obligation (USO) is set forth in 39 U.S.C. § 101(a) and provides a framework for analyzing the types of postal services that are 'of the kind and quality adapted to the needs of the United States.'").

United States at any given point in time, and hence the revenues needed to provide such services. In this regard, two fundamental aspects of the statutory structure are important.

First, as the Commission has previously recognized, the statutory standards governing the levels of service provided by the Postal Service are, with some notable exceptions, qualitative in nature. Therefore, these standards enable the Postal Service to adjust its service parameters to account for changing circumstances, particularly so that it can balance rate levels with costs. In its report on the USO, the Commission noted that:

> The USO is not specific. The Postal Service is to achieve the best possible balance of these service features consistent with efficient and economic practices. Congress has rarely established rigid, numerical standards of minimally acceptable service for each of these features. Rather, throughout its history, the Postal Service has been expected to use its flexibility to meet the needs and expectations of the Nation while balancing the delivery of service against budgetary constraints. This long-standing policy has worked well.[133]

Section 3961 also reflects this fact, as it allows service standards to change so long as they achieve a number of objectives, including the objective that the standards must "reasonably assure Postal Service customers delivery reliability, speed and frequency consistent with reasonable rates and best business practices."[134] Furthermore, in considering changes to the service standards, the Postal Service is

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[133] Postal Regulatory Comm'n, Report on Universal Postal Service and the Postal Monopoly 3 (2008). *See also* Order No. 1926 at 25 (noting that what exactly constitutes "postal services . . . adapted to the needs of the United States" is "an ever-evolving concept.") (citing Postal Regulatory Comm'n, Report on Universal Postal Service and the Postal Monopoly at 15-84); *id.* at 35 (noting that "postal needs change over time for the same, or similar, reasons that the Postal Service's universal service obligation changes").

[134] 39 U.S.C. § 3691(b)(1)(C).

required to take into account factors such as customer needs, mail volume and revenues projections, delivery point growth, the costs of providing service to customers, and "the effect of changes in technology, demographics, and population distribution on the efficient and reliable operation of the postal delivery system."[135]

Congress has therefore created a structure in which the Postal Service is not only allowed, but "expected," to adjust service levels to account for the changing usage of the mail by the American people, as part of an overall policy that it provide postal services in a self-sufficient, business-like manner. Achieving this policy necessarily requires the Postal Service to continually evaluate the appropriate balance between service levels and rate levels. This leads to a fundamental conclusion: changes to the levels of service provided by the Postal Service cannot rationally be held to be inconsistent with the objectives, or with the statute generally, so long as they are consistent with the qualitative standards setting forth the Postal Service's universal service mission, and hence constitute an appropriate balance between the costs required to provide a level of service, and the rate levels needed to cover those costs.

As such, the fact that service levels may change cannot rationally be considered a basis to reduce the Postal Service's ratemaking authority. Reducing service levels to account for declining demand for postal services, caused by factors such as electronic diversion and changing demographics, to thereby ensure a better alignment between the costs of the Postal Service's network and available revenues (to be derived from reasonable rates), is fully consistent with the statute, so long as the new service levels still adhere to the standards set forth by Congress. Particularly given mail volume

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[135] 39 U.S.C. § 3691(c)(3)-(7).

trends – which necessitate comprehensive action regarding both price and cost in order for the Postal Service to maintain financial stability – it would make no sense for the Commission to interpret the objectives as mandating that the financial benefits of such service level changes must be counteracted by reducing the Postal Service's ability to raise rates.[136]

Second, when it comes to making the determination about appropriate service levels, the Commission's role is primarily advisory in nature. The Commission plays an advisory and consultative role regarding the establishment of, and changes to, the Postal Service's service standards for market-dominant products, which is the subject of Objective 3.[137] The Commission is also tasked with issuing non-binding advisory opinions for all other nationwide or substantially nationwide changes in service.[138] Similarly, the Commission's role when it comes to individual post office closings and consolidations is to ensure that the Postal Service has followed the requirements of the law, but without substituting its judgment for that of the Postal Service regarding the final decision whether to close or consolidate a post office.[139]

Therefore, the authority to implement the provisions of law that govern the provision of universal service – and hence to determine what service levels are appropriate to meet the current needs of the Postal Service's customers at a given point in time – rests in the first instance with the Postal Service, rather than the Commission.

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[136] This issue is distinct from service performance within the service levels set by the Postal Service. The Commission has regulatory authority (under statutory provisions not subject to this review) to oversee the Postal Service's service performance. 39 U.S.C. §§ 3653, 3691.

[137] *Id.* § 3691(a).

[138] *Id.* § 3661(b)-(c).

[139] *Id.* § 404(d).

The Commission should be mindful of this fact when it considers how to interpret and apply the objectives. As noted above, Objective 3 requires that the regulatory system enable the maintenance of "high-quality service standards." It would vitiate the structure of Section 3691 for the Commission to utilize its regulatory authority under Section 3622 in a manner designed to dictate or influence Postal Service decision-making regarding the service standards themselves, or service levels more generally. In general, a decision by the Postal Service to maintain a particular service level, based on its assessment of current needs of its customers, should not be seen as being inconsistent with Objective 1 unless the Commission concludes that the Postal Service's failure to change the service level falls wholly outside the bounds of efficient management.

In this regard, the Commission has previously recognized that, given the Postal Service's public service mandate, efficient management does not mean taking any and all actions to reduce costs in the short term; rather, it requires a "balance[between] financial responsibility and the need to provide postal services of the kind and quality adapted to the needs of the United States."[140] "Unlike a private enterprise, the Postal Service must consider the impact of its cost-cutting activities on its ability to continue to provide postal services consistent with the policies of title 39, United States Code."[141] These considerations clearly apply in the context of interpreting and applying Objective 1.[142] In other words, Objective 1 cannot be interpreted as mandating that the Postal

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[140] Order No. 1926 at 127-28 & fn.119.

[141] *See id.* at 131. *See also id.* at 118 (recognizing that generating certain additional cost savings through further consolidations of network facilities and delivery operations "cannot be achieved without a further reduction in service or mailing service standards").

[142] In addition to balancing cost savings against service needs, the Postal Service must also be cognizant of the possibility that service reductions, even if they may generate cost savings in the short term, could negatively affect the Postal Service because of their potential impact on volumes; such a reduction would

Service implement any and all reductions in service levels that, while arguably consistent with the qualitative standards set forth in the statute, are reasonably considered by the Postal Service to still be appropriate to meet the current postal needs of the United States.

4. Competitive products are relevant to assessing several objectives.

The revenues from the Postal Service's competitive products are of course relevant to assessing the revenues that must be generated from market-dominant products in order to ensure the Postal Service's financial stability. As noted above, financial stability necessitates the Postal Service's ability to sustainably cover its costs, service its liabilities, and have an appropriate level of liquidity reserves. Meeting this goal requires the Postal Service to generate an appropriate level of retained earnings. Any revenues provided by competitive products above their attributable costs advances the achievement of the Postal Service's financial stability.[143]

Objective 9 also requires that the market-dominant regulatory system be designed "[t]o allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products." In Order No. 3673, the

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make sense neither from the perspective of "financial responsibility" nor from the perspective of providing a public service.

[143] In this regard, inhibiting the Postal Service's ability to compete fully and fairly on the competitive side would harm users of market-dominant products, by reducing competitive revenues over the long-term, and hence necessitating higher rate levels for market-dominant products than would otherwise be necessary. *See* Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, Docket No. RM2007-1 (Aug. 15, 2007), at 72 (noting that the Postal Service's ability to retain earnings gives it "incentives to exceed this threshold [that is, the 'appropriate share' of institutional costs that competitive products must collectively cover]," and therefore to "reduc[e] rate pressure on market dominant rates"); *see also* Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 6 ("The new incentive of the Postal Service to exceed the floor [per Order No. 26] reduces the need to mandate a higher level of contribution.").

Commission correctly observes that this objective is related to the "appropriate share" provision in the regulatory regime for competitive products, which must be periodically assessed by the Commission in light of marketplace conditions (and is, in fact, currently the subject of Docket No. RM2017-1).[144] Both Objective 9 and Section 3633(a)(3) deal with the same issue ("allocating" the Postal Service's "institutional costs") and use the same term ("appropriate[ly]"), which indicates that Congress intended the two provisions to be applied in a congruent manner.[145] Therefore, achievement of Objective 9 is effectuated, from the standpoint of competitive products, through the Commission's implementation of Section 3633(a)(3): so long as the Postal Service's competitive products are meeting the "appropriate share" provision, institutional costs are being "allocated . . . appropriately" to competitive products for purposes of this Objective.

At the same time, the "appropriate share" under Section 3633(a) is considered to be a floor, not a target or ceiling, for the derivation of competitive revenues above attributable costs. As the Commission explained in Docket No. RM2007-1, the PAEA's appropriate share requirement "is a floor for all competitive products, but the hope (and expectation) is that competitive products will generate contributions in excess of the floor."[146] Indeed, as discussed in Docket RM2017-1, the Postal Service has consistently exceeded the "appropriate share" by a wide margin in recent years. Competitive revenues generated above the appropriate share are, in turn, used to

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[144] Order No. 3673 at 10 (citing 39 U.S.C. § 3633(a), (b)).

[145] *Util. Air Regulatory Group,* 573 U.S. at __, 134 S. Ct. at 2441 ("One ordinarily assumes that identical words used in different parts of the same act are intended to have the same meaning.") (citation and quotation marks omitted).

[146] Order No. 26 at 72.

support the financial stability of the Postal Service as a whole, and hence benefit market-dominant mailers.[147]

Therefore, if the Postal Service is to actually achieve and maintain financial stability, and thus to achieve Objective 5, the system must give the Postal Service the capability to generate from market-dominant products any additional revenues necessary to maintain financial stability that are not generated from the competitive side in a manner that is compliant with Section 3633. Moreover, a failure on the part of the system to allow the Postal Service to use market-dominant products to ensure that all institutional costs are being covered would mean that Objective 9 is also not being achieved.

C. To Achieve the Objectives, the Regulatory System Must Allow the Postal Service Pricing Flexibility Consistent with Applicable Legal Requirements.

Many of the objectives address the ratemaking process at a more granular level, concerning the mechanisms that are used to set rates, and the specific rates (including rate relationships) that result from that process. For instance, Objectives 4 and 8 state that the system must "allow the Postal Service pricing flexibility," consistent with maintaining "a just and reasonable schedule for rates and classifications," while Objective 6 requires the system to be transparent but not administratively burdensome. The Commission, meanwhile, has proposed that Objective 1 incorporate principles of pricing efficiency, and Objective 2 concerns the need for customers to have rate levels that change in a predictable and stable manner. The Commission has generally set

[147] A portion of the revenues generated above the appropriate share is distributed to the Postal Service Fund pursuant to Section 3634. The Postal Service also transfers the remaining amount of excess revenue to the Postal Service Fund to support the Postal Service's ability to maintain operations.

forth reasonable definitions of these various objectives, subject to the discussion of certain specific issues below.

1. Efficient component pricing

The Commission states that "pricing efficiency" is an element of Objective 1, and that one way to measure pricing efficiency is by considering whether prices "adhere to the principles of efficient component pricing "[148] Currently, the statute only states that workshare discounts cannot exceed the Postal Service costs avoided through the worksharing activity, except in certain circumstances.[149] While the Postal Service does not quibble with the Commission's proposal that considering how prices relate to ECP be an aspect of Objective 1, the Commission should reject any arguments that this should lead to the full application of ECP, such that the Postal Service would also be restricted from setting discounts below avoided costs, unless certain exceptions are met. This is discussed in section VI.G below.

2. Minimum rates

Another issue is whether the specific rates that can be set by the Postal Service enable individual market-dominant products to cover their costs. While there is a clear statutory requirement that each competitive product cover its attributable costs, the statute does not impose such an unequivocal mandate for market-dominant products.[150] Rather, Factor 2 states that the Commission should "take into account" a "requirement"

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[148] Order No. 3673 at 4.

[149] 39 U.S.C. § 3622(e).

[150] *See* Order No. 3641, Order Adopting Final Rule on Changes Concerning Attributable Costing, Docket No. RM2016-3, at 10-11 (Dec. 1, 2016) (contrasting competitive products and market-dominant products when it comes to individual product cost coverage).

that each “class and type of mail service” cover its costs.[151] Moreover, the Commission has interpreted Section 101(d) as mandating that the cost coverage of market-dominant products not be persistently and excessively low, based on a totality of the circumstances test; however, the Commission has noted that this provision also does not mandate full cost coverage for all market-dominant products.[152]

The Commission has therefore appropriately rejected arguments that the statute demands that each market-dominant product must invariably cover its costs, finding that the statute is instead more nuanced when it comes to assessing the appropriateness of the cost coverage of market-dominant products.[153] The Postal Service considers that market-dominant products should cover their incremental costs as a matter of sound pricing policy. However, when considering cost coverage issues beyond the minimum requirements of Section 101(d), the circumstances of each product must be considered by the Postal Service, based on a balancing of the various pricing policies set forth in the statute (as reflected in Objective 4). Moreover, cost coverage for a particular product cannot be pursued at the expense of the Postal Service’s overall financial stability.

IV. THE CURRENT SYSTEM FAILS TO ACHIEVE CRITICAL OBJECTIVES, AND ITS FEW ACHIEVEMENTS CANNOT MAKE UP FOR ITS MANIFOLD FAILINGS (QUESTION 3).

It is abundantly clear that the current price cap system is not capable of fulfilling all, or even most, of the statutory objectives. For instance, the price cap has patently

[151] 39 U.S.C. § 3622(c)(2).

[152] *See generally* Order No. 1427, Order on Remand, PRC Docket No. ACR2010-R (Aug. 8, 2012).

[153] Order 3641 at 10-11 (rejecting Valpak proposal that it change its rules to require each market-dominant product to cover its costs).

failed to assure adequate revenues to maintain the Postal Service's financial stability, or to enable rates that are "just and reasonable." This lack of adequate revenues due to the price cap's rigidity, in turn, threatens the achievement of other objectives, such as maintenance of high-quality service, mail security, and efficiency improvements. What few objectives and factors the current system can be said to satisfy, those accomplishments do not save the current system from its fatal shortcomings. Moreover, this conclusion cannot be waved away in favor of hypothesized efficiency gains or cost cuts: while the Postal Service has and will continue to aggressively pursue such efforts, the available opportunities come nowhere close to enabling the Postal Service to maintain financial stability under the current price cap. Finally, the Commission cannot use the prospect of postal reform legislation as a basis to justify the current system. The Commission must confront the fact that the cap has failed.

A. The Current System Has Not Produced Just and Reasonable Rates or Adequate Revenues to Ensure Financial Stability (Objectives 5 and 8; Factor 4).

The current system has not enabled the Postal Service to be financially stable or have just and reasonable rates, even though postal management has practiced honest, efficient, and economical management. As another party pointed out in a recent proceeding, "economists . . . since the 1840s" have recognized that "an inherent structural characteristic of firms with joint and common costs" is that they "must cover all of [their] costs to stay in business over the long run. . . . The firm will survive – indeed, thrive – over the long run as long as its prices in the aggregate cover the firm's total costs."[154] Thanks to its rigidity in the face of rapid and unexpected changes to the

[154] Reply Comments of Amazon Fulfillment Services, Inc., PRC Docket No. RM2016-2 at 11.

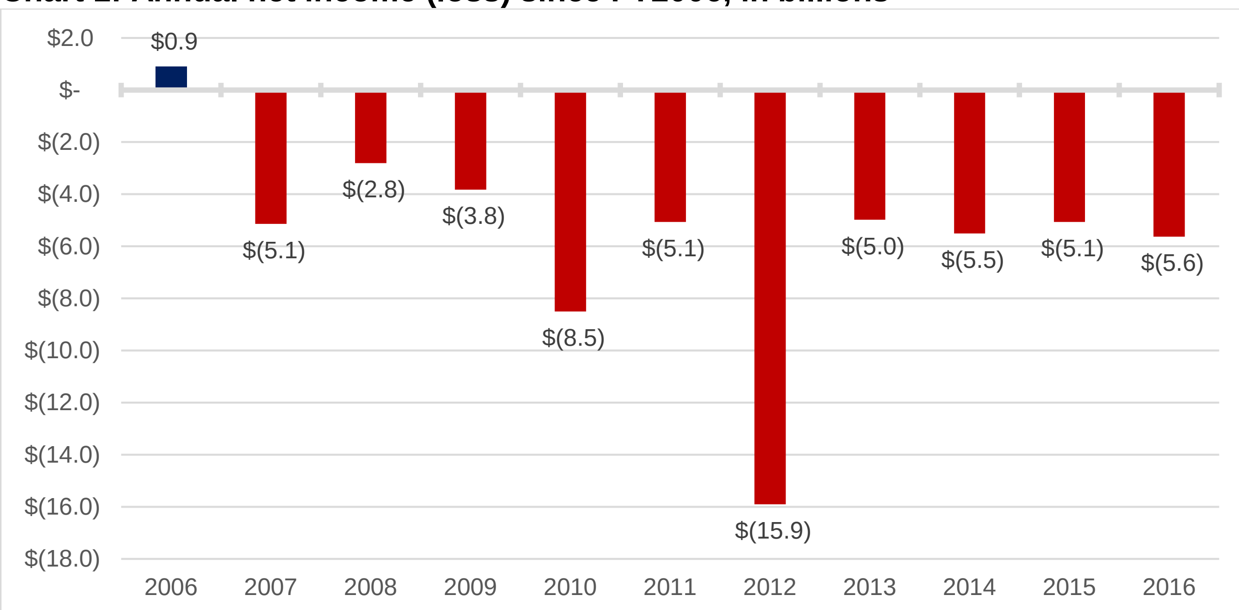
Postal Service's business environment, however, the current system has failed to enable the Postal Service to cover its costs at all, much less maintain financial stability.

1. The current system could not sustain the Postal Service amid the sort of volume declines that have prevailed since the PAEA.

a. The Postal Service's overall financial health is dire.

The Postal Service has had a net loss in every year since the PAEA was enacted in 2006. Overall, the Postal Service has incurred cumulative net losses of $62.4 billion since FY2007, and it has exhausted its borrowing authority.

Chart 1: Annual net income (loss) since FY2006, in billions[155]



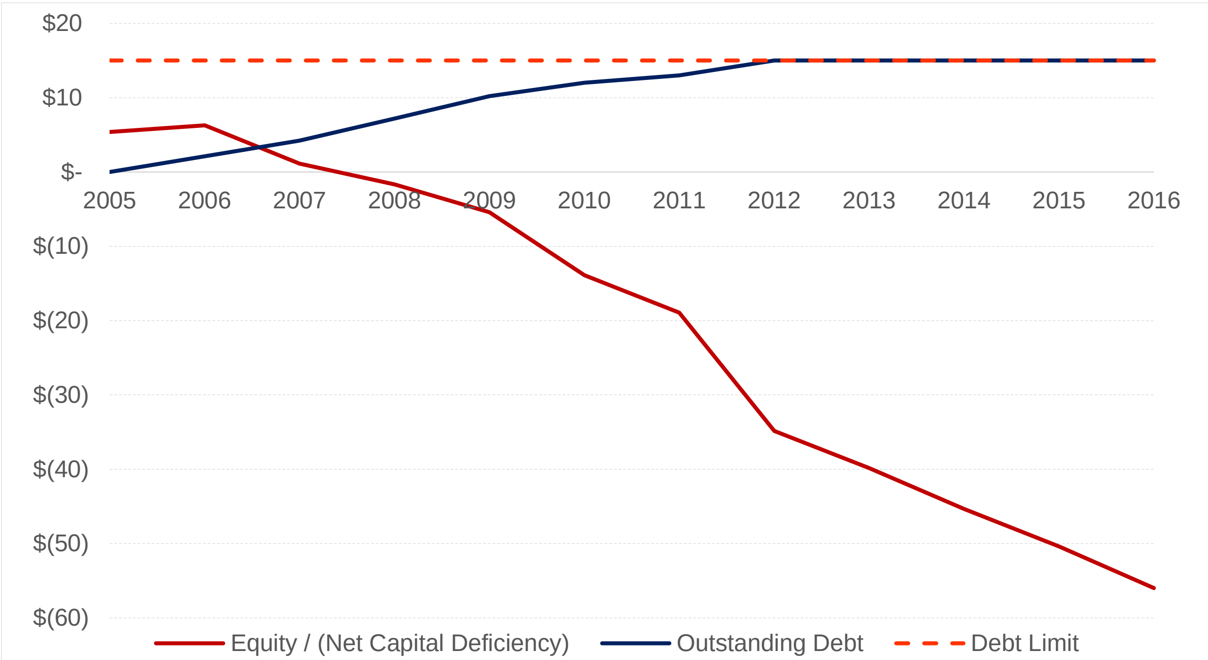
The Postal Service entered the PAEA with $6.3 billion in equity, but it now has a net capital deficiency of $56.0 billion.[156] It also entered the PAEA with only a modest level

155 *See* Appendix B at 13.

156 Even if the initial equity is adjusted for the amount in escrow at that time that was expensed soon afterward, the Postal Service still entered the PAEA period with positive equity of $3.3 billion. Also, the relatively small difference between the total net loss ($62.4 billion) and the change in equity ($62.3 billion) consists of $98 million in additional capital contributions by the U.S. Government in 2009 and 2010, based on the net value of fuel-efficient vehicles provided to the Postal Service under the American Recovery and Reinvestment Act of 2009. *See* U.S. Postal Serv., Form 10-K for FY2010 (2010), at 60.

of debt, but it has exhausted its borrowing authority. The chart below illustrates this situation.

Chart 2: Equity (net capital deficiency) and outstanding debt since FY2005, in billions of dollars



These losses are the result of the confluence of several factors, primarily the accelerated loss of market-dominant mail volume, which has declined by 29 percent since FY2006. Even with respect to "controllable costs," a term that does not count RHB prefunding payments and certain other expenses (the non-cash workers' compensation liability adjustments and, more recently, the FERS amortization payment calculated by OPM), the steep drop in volumes still caused the Postal Service to suffer losses every year between FY2009 and FY2013 due to the lower mail volumes. It would have continued to do so in FY2014, FY2015, and FY2016 but for the now-expired exigent surcharge.[157]

The end result of this decade of losses is that the Postal Service has dangerously low liquidity and lacks the ability to meet all of its financial obligations. Within six years of the enactment of the PAEA, the Postal Service had exhausted its line of credit with the U.S. Treasury and was left with approximately $2.1 billion of unrestricted cash on hand.[158] Although the Postal Service has nominally increased its liquidity since then (by increasing available cash to a total of $8.1 billion in FY2016), that seeming achievement is artificial, for two reasons. First, because of the inadequate revenues provided by the price cap in a declining-volume environment, the Postal Service could only retain a lifeline of cash by defaulting on $33.9 billion in statutorily-mandated RHB payments over the past five years. Second, the plunge in liquidity only reversed in FY2014-FY2016, when the exigent surcharge provided $4.6 billion in incremental revenue above the price cap. Without that boost, cash on hand would have been only $3.5 billion, rather than $8.1 billion, in FY2016, all else being equal. In other words, the Postal Service could only achieve its current liquidity position by failing to fulfill its statutory obligations and despite, not because of, the price cap. Moreover, the

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[157] *E.g.*, Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2015 (2016) [hereinafter "FY2015 Financial Analysis Report"], at 1-2 (listing FY2015 net operating income as $1.2 billion and exigent surcharge revenue as $2.1 billion).

[158] *Id.* at 2. *See also* Order No. 1926 at 116-117 (noting the Postal Service's "rapid decline" in liquidity over this period, and also that liquidity is "the most important requirement for any business organization.") (citation omitted).

exigent surcharge is now gone, and the Postal Service expects liquidity to resume its previous downward trend.[159]

Even with defaults on mandated payments, the Postal Service still has inadequate cash reserves to buffer it against contingencies. The Postal Service's available cash as of the end of FY2016 could sustain it for only 29 days in the event of an emergency: a level insufficient for an organization of the Postal Service's size.[160] In his recent testimony, Chairman Taub extensively discussed the Postal Service's insufficient and declining liquidity, cautioning that "[i]f a downturn in the economy or other circumstance should further stress the Postal Service's cash flow, it risks not being able to pay some of its bills and could, in a worst case scenario, run out of cash."[161] Again, however, the Postal Service has already been unable to "pay some of its bills": it has defaulted on $33.9 billion of mandated RHB prefunding payments.[162] (As discussed in section IV.F.1 below, continuation of the current system would perpetuate the Postal Service's inability to meet its legal obligations to fund post-retirement benefits.)

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[159] United States Postal Serv., Fiscal Year 2017 Integrated Financial Plan 4, 8-9 (filed at the Commission Dec. 2, 2016).

[160] *Id.*; *see* Appendix B at 38, 44-46, 60 (contrasting the Postal Service's liquidity levels with the much greater levels among comparable foreign postal operators and federal utilities, and opining that, "[i]n the absence of USPS having additional borrowing authority[,] 24 days of cash on hand [in FY2015] is not consistent with financial stability").

[161] Accomplishing Postal Reform in the 115th Congress – H.R. 765, the Postal Service Reform Act of 2017: Hearing Before the House Oversight & Gov't Reform Comm., 115th Cong. (Feb. 7, 2017) (statement of Robert G. Taub, Chairman, Postal Regulatory Commission), https://oversight.house.gov/wp-content/uploads/2017/02/Taub.pdf [hereinafter "Taub Testimony"], at 10.

[162] United States Postal Serv., FY2016 Report on Form 10-K (2016), at 47. As Evercore explains, continued nonpayment of these defaulted amounts would leave the RHB liability substantially unfunded, making the Postal Service's liabilities-assets ratio even more lopsided and threatening the ability of the RHB Fund to cover retirees' health care costs. Appendix B at 57-58.

Moreover, constrained liquidity does not allow the Postal Service to invest adequately in long-deferred but necessary capital investments. The Commission has found that

> Postal Service liquidity is insufficient to significantly improve operational efficiency. Liquid assets (current assets) are insufficient to meet the payment of current liabilities. . . .
>
> All current activity is financed with internally generated cash, which severely limits the Postal Service's capability to invest in productive assets. The initial capital contributions, coupled with small surpluses in the years prior to FY 2006, are not sufficient to fund all the Postal Service's current obligations.[163]

The lack of capital to invest "is significant to the entire postal system," as "[i]nsufficient capital investment could impair the Postal Service's ability to meet the delivery requirements of the USO, service performance could be impacted, and access to postal services could be substantially impacted."[164]

The impact of inadequate liquidity on capital investment is not merely theoretical. The Postal Service faces a pressing need to make significant additional capital investments in order to improve productivity and continue providing prompt, reliable, and efficient universal service. Over the past several years, the Postal Service has been forced to reduce or defer all but essential capital investments in order to maintain liquidity. Between FY2008, when the price cap and the acceleration of volume declines took hold, and FY2016, the Postal Service's cumulative capital investments were almost $10 billion below what might have been expected from the FY2000-FY2007 average

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[163] FY2014 Financial Analysis Report at 2, 22.

[164] Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2013 (2014), at 17.

level, and FY2015 capital investments were far below those of large private delivery companies.[165]

Chart 3: Postal Service annual capital expenditures, FY2008-FY2016, and average annual capital expenditures, FY2000-FY2007, in billions of dollars[166]

Although this was a necessary short-term response to the Postal Service's financial crisis, the continued deferral of investment cannot be maintained if the Postal Service is to be able to continue providing appropriate levels of service in an efficient manner. The Commission has previously recognized these facts, noting both that capital investments are essential to providing universal service, and that capital spending must be increased from current levels.[167] Overall, investments are needed to sustain,

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[165] United States Postal Service Office of the Inspector Gen., RARC-WP-16-009, Peeling the Onion: The Real Cost of Mail (2016) [hereinafter "OIG, Peeling the Onion"], at 2, 4-5, 14-16 (finding that 2015 capital expenditures were one-half of 2006-2007 levels, well below UPS and FedEx's inflation-adjusted capital expenditures, and lagging behind depreciation and amortization of the Postal Service's assets).

[166] This chart is adapted from information on purchases of property, plant, and equipment in the Postal Service's Form 10-K reports for the relevant years.

[167] FY2014 Financial Analysis Report at 24 ("Capital investments in physical resources are necessary to increase and maintain productivity. For the Postal Service to effectively compete in the e-commerce

modernize, and improve the Postal Service's information technology infrastructure, its facilities and processing infrastructure, and its delivery infrastructure, particularly its aging fleet of delivery vehicles. The deferral and reduction of these investments has already begun to drag on the Postal Service's efficiency efforts.[168]

b. These financial woes stem from postal legislation premised on expectations that soon proved unrealistic amid an economic downturn and accelerating electronic substitution (Factor 4).

When the PAEA was enacted and the current system introduced, most stakeholders reasonably expected that the system Congress initially established would enable the Postal Service to finance universal service into the future. As noted above, Congress enacted the PAEA for this purpose, and therefore implicitly assumed in specifying the current CPI cap for the first 10 years that volume trends, coupled with the Postal Service's continued pursuit of cost reductions and efficiency gains, would allow the Postal Service to be financially sustainable despite the rigid cap on market-dominant prices, inexorable growth in delivery points, no new cost-cutting authority, and significant new post-retirement benefits prefunding burdens. Unfortunately, this did not prove to be the case, because the assumptions underlying the current system did not remain valid as the nation fell into a deep recession, electronic diversion accelerated, and mail volumes plummeted to what the Commission has recognized as a new, lower normal. Far from the price cap enabling retained earnings through efficient management, the Postal Service has suffered substantial net losses each year.

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market, it will need to make capital investments in suitable delivery vehicles. It also needs to replace its existing aging vehicles to accommodate the shift in mail mix toward a larger share of packages relative to letter- and flat-shaped pieces of mail. The Postal Service must also invest in new and efficient mail processing technologies and equipment. However, its ability to make these investments is diminished by the lack of available working capital."); Order No. 1926 at 119-22.

[168] FY2015 Financial Analysis Report at 19, 28.

The PAEA embodies three central policy choices: (1) prices for market-dominant products, which currently account for approximately 73 percent of total mail and services revenue, would be capped at CPI-U for at least ten years, except in very restrictive circumstances; (2) the Postal Service would receive no augmented authority to control its costs; and (3) the Postal Service would prefund 100 percent of its unfunded RHB liability on an accelerated schedule.[169] Congress assumed that the Postal Service could maintain financial stability without more latitude in these three areas, even in the face of electronic diversion, and that product and pricing innovations and cost-cutting within the Postal Service's control would be enough not only to make ends meet, but even to furnish retained earnings for funding network expansion and capital investments.[170] However, any prospect that the PAEA might have worked more or less as planned in its first decade was eliminated by the volume declines that actually occurred.

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[169] Although it did not affect the first decade of the PAEA, the law's framers also expected that the Postal Service would be able to make CSRS amortization payments after a ten-year holiday.

[170] *See* S. REP. NO. 108-318, at 8 ("The long term financial viability of the Postal Service is addressed by requiring that the Postal Regulatory Commission maximize incentives for the Postal Service to reduce costs and increase efficiency (Objective [1]) thus maintaining affordable and cost-effective postal services. . . . [T]he ability to retain earnings will provide the Postal Service with revenues necessary to fund network expansion and necessary capital improvements.").

Chart 4: Total mail volume, FY2000-FY2006, with President's Commission projection (as of 2003), in billions[171]

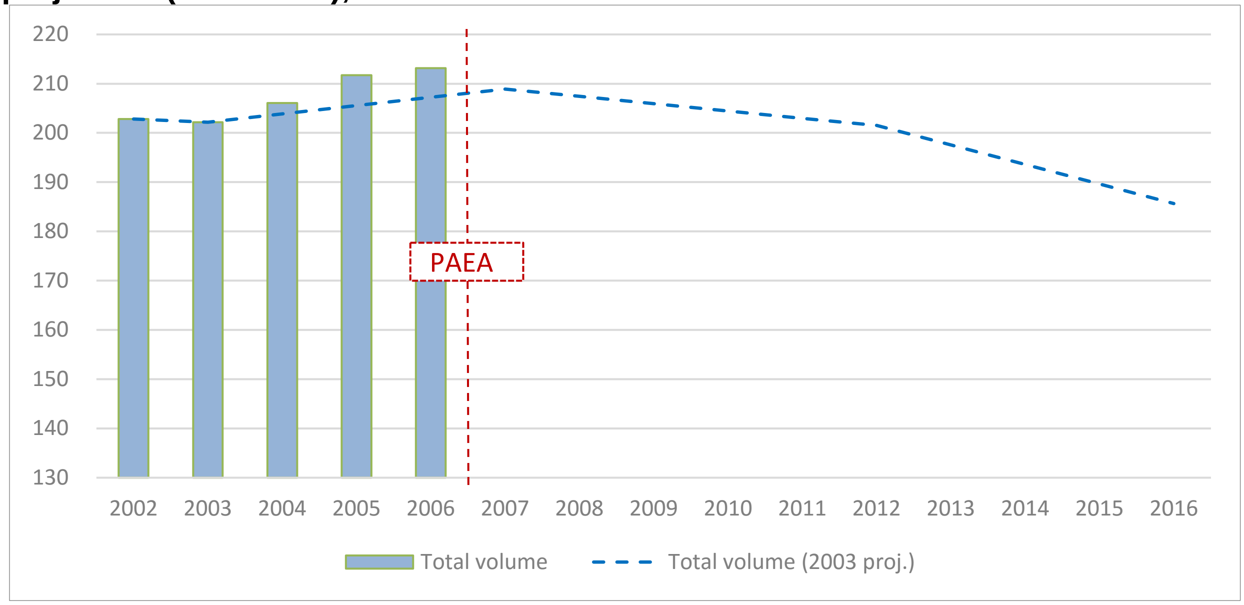
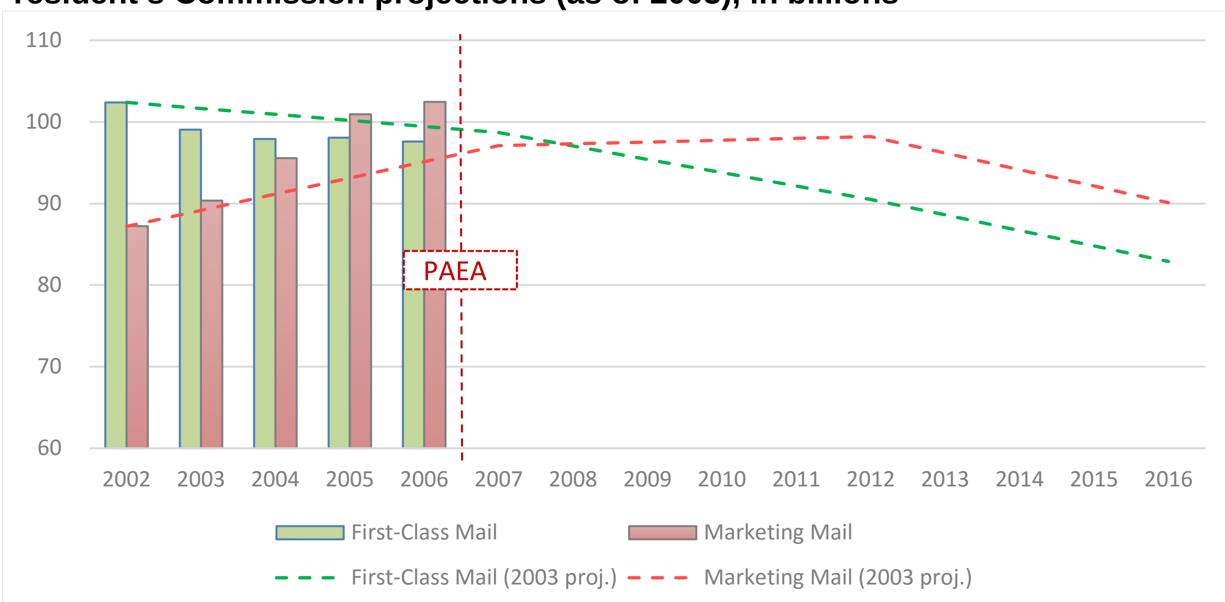


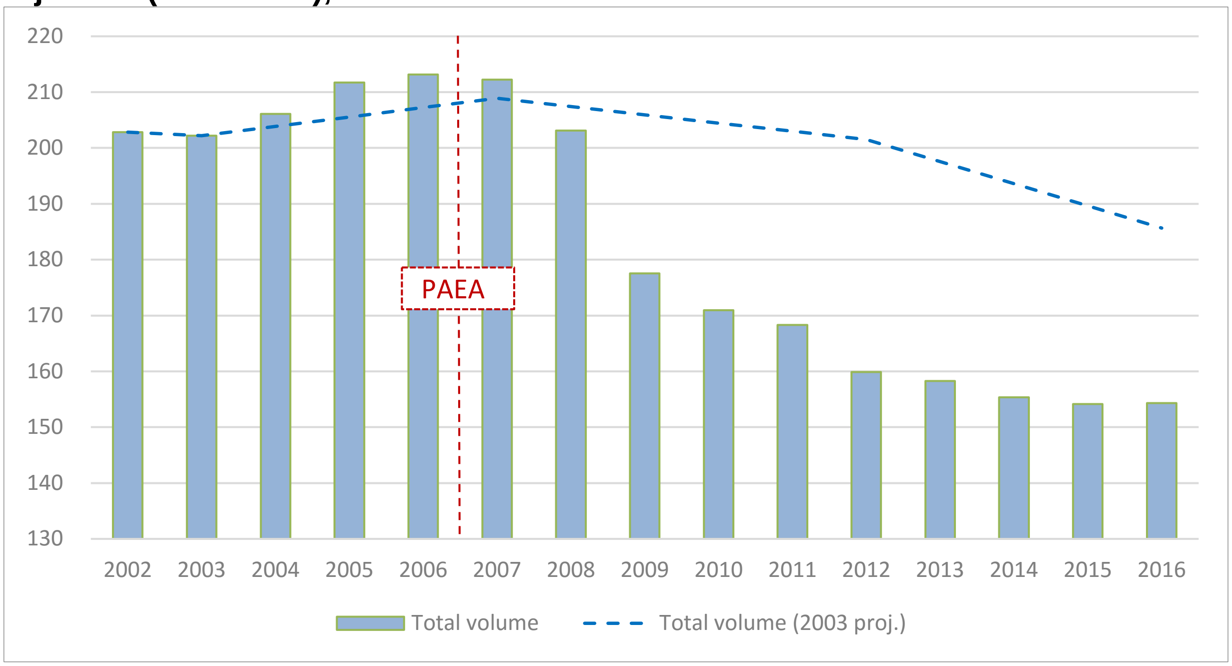
Chart 5: First-Class Mail and Marketing Mail volume, FY2000-FY2006, with President's Commission projections (as of 2003), in billions



171 Actual volumes in this and the following three charts, as well as in the accompanying text, are adapted from data in Cost and Revenue Analysis Reports (CRAs) for the relevant years. Projected volumes refer to the President's Commission Report at 5. It should be noted that the President's Commission used actual FY2002 volumes and project volumes for FY2007, FY2012, and FY2017. The lines shown on these charts connect the point estimates, but they do not necessarily represent what the President's Commission would have projected for years between the reference years.

Congress did undoubtedly have an appreciation for the prognosis of declining First-Class Mail volume and hence changes to the mail mix.[172] However, Congress, the Postal Service, and other stakeholders failed to anticipate the financial hurricane lurking just beyond the horizon, in terms of either its overall savagery or the extraordinary volume declines that occurred in its wake. In the fiscal year that ended just prior to the enactment of the PAEA (FY2006), the Postal Service had its highest volume ever, totaling 213 billion pieces of mail. While the long-term challenges from electronic diversion were a problem that the Postal Service had identified and was responding to, the chart below shows that the accelerated loss of mail volume that began soon after the enactment of the PAEA was nothing short of staggering, compressing what was seen as a long-term, gradual decline into only a few years.

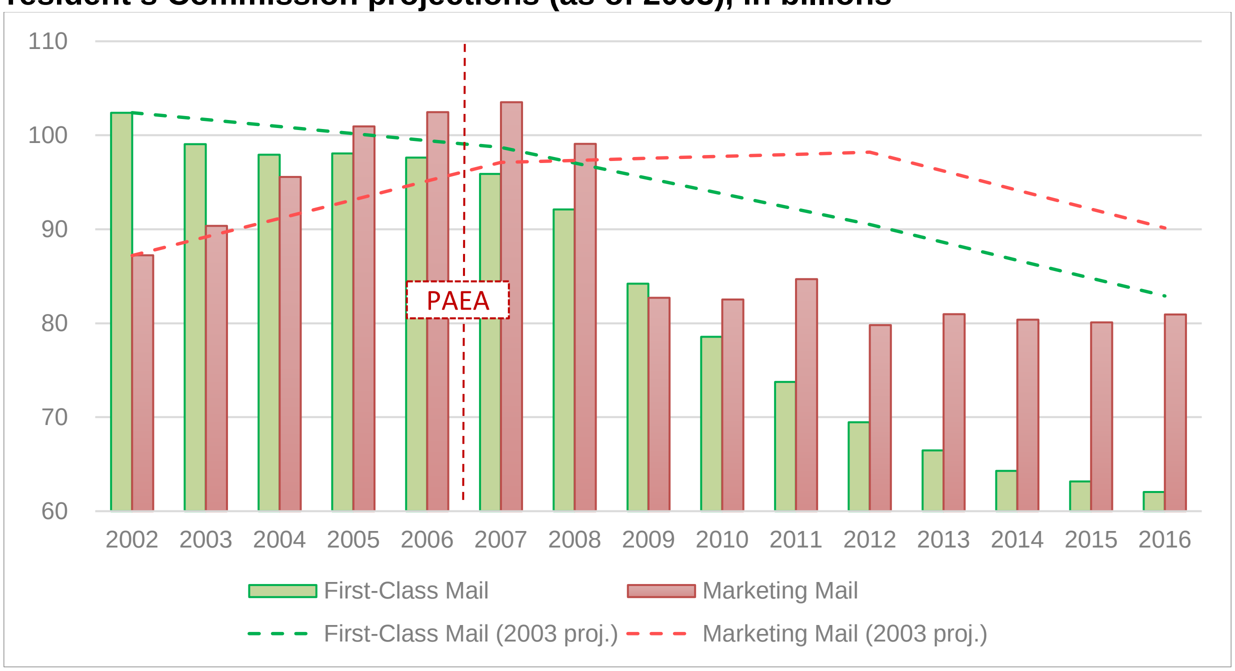
Chart 6: Total mail volume, FY2000-FY2016, with President's Commission projection (as of 2003), in billions



[172] H.R. REP. NO. 109-66, pt. 1, at 42.

Class-level trends similarly confounded expectations. For example, pre-PAEA trends provided no basis to expect that First-Class Mail volume would plummet by 24 billion pieces, or almost 25 percent, from FY2006 to the end of FY2011. This vastly exceeded the decline for the previous five-year period, in which First-Class Mail shed only 6 billion pieces, or 6 percent, compared with its FY2001 peak. The PAEA's framers similarly could not have expected that, in 10 years, First-Class Mail volume would have sunk to a level not seen in the 25 years prior to the PAEA. Nor was it expected that Marketing Mail volume would decline by an estimated 21.5 billion pieces, or 21 percent, from FY2006 levels, after growing for most of the decade.

Chart 7: First-Class Mail and Marketing Mail volume, FY2000-FY2016, with President's Commission projections (as of 2003), in billions[173]

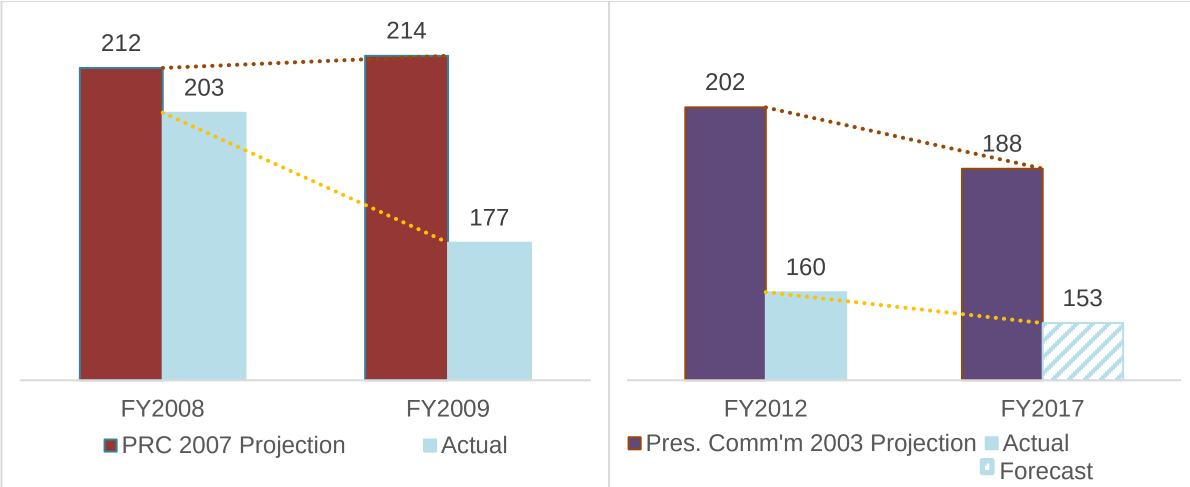


[173] Actual First-Class Mail volumes before FY2007 exclude international items, which were reported separately in the CRAs prior to their inclusion within the First-Class Mail class in Docket No. RM2007-1. Because First-Class Mail International volumes comprise a relatively small portion of total First-Class Mail volume, this discrepancy does not materially affect the pattern shown in this chart.

The Postal Service now faces a situation in which its volume and revenue are substantially, dangerously lower than stakeholders expected at the time the PAEA was debated and enacted. The table below illustrates this through a comparison of actual volumes with pre-PAEA or immediately post-PAEA projections. As late as 2007, the Commission expected volumes to rise in the coming years, rather than falling off a cliff. For its part, the President's Commission on the United States Postal Service (President's Commission) presented what was regarded in 2003 as a relatively pessimistic volume-decline scenario; today, that scenario looks wildly optimistic, with actual volumes in FY2009 already having sunk below where the President's Commission expected them to be eight years later. Indeed, the Commission has already found that the "severity of [the Great Recession-era volume declines] was unforeseeable by any reasonable standard."[174]

[174] Order No. 547 at 52.

Chart 8: Comparison of actual volumes with projections by the Commission in 2007 and the President's Commission in 2003, in billions[175]



As the Commission recognized in finding that this level shift in volume constitutes a "new normal," there is no reasonable expectation that this lost volume will ever return. Individuals and businesses that have switched to electronic communications, bill presentment, and bill payment channels are unlikely to revert to the mail. The Postal Service projects that volumes will decline at a consistent pace, as discussed in section IV.F.1 below.

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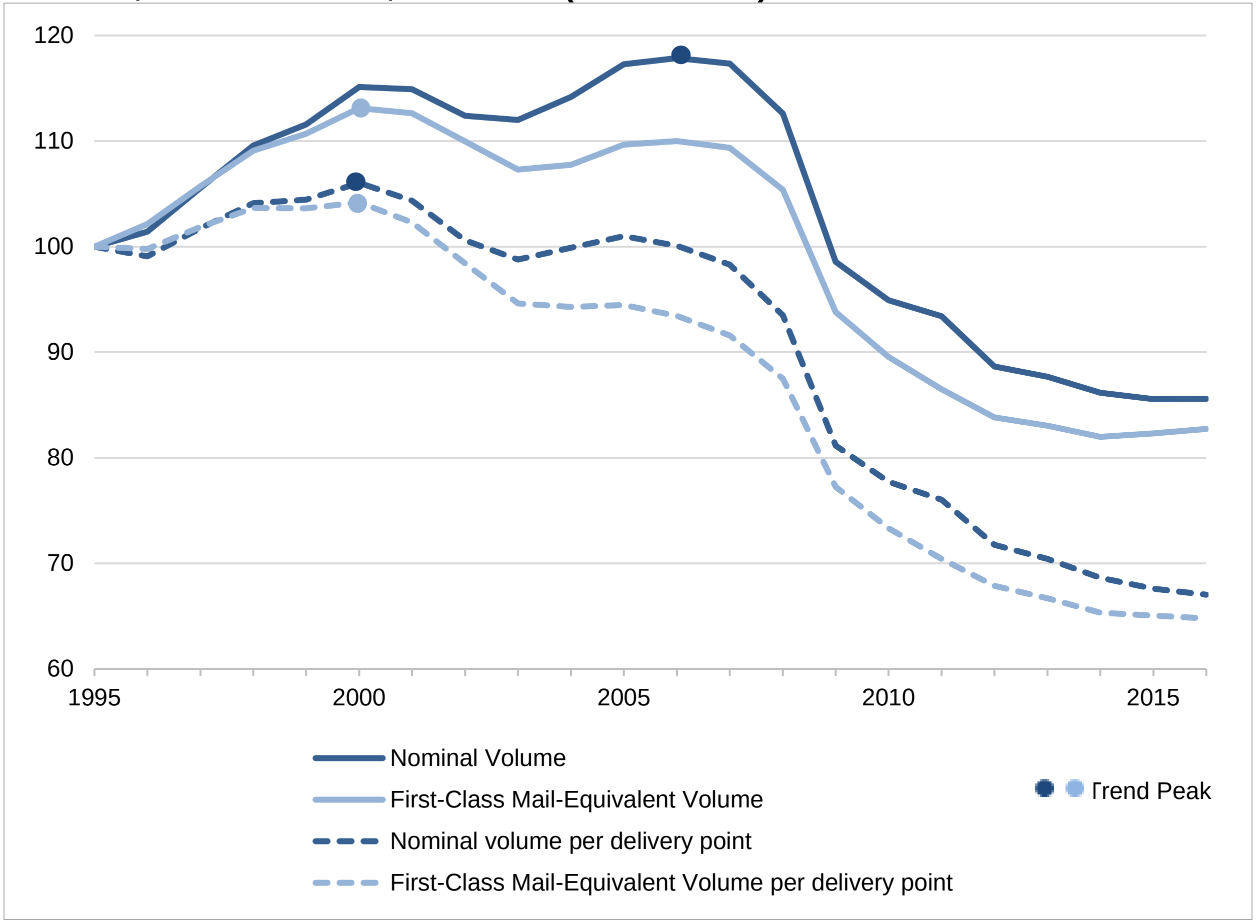
[175] *Compare* Fixed Weight Indices, Volume Forecasting, First-Class Revenue Calculation, and Summary of Test Year Finances, Library Reference PRC-LR-23, PRC Docket No. R2006-1 (Apr. 27, 2007), Microsoft Excel file "all_r06prclr23.xls," at tab "VOL," cells BY69 & CF69; *and* President's Commission Report at 5, *with* U.S. POSTAL SERV., FISCAL YEAR 2017 INTEGRATED FINANCIAL PLAN 5 (2016); Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2012 (revised May 7, 2013), at 207; Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2009 (Mar. 29, 2010), at 30; *and* Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2008 (Mar. 30, 2009), at 12. The President's Commission assumed "gradual displacement" of the mail by electronic means, consistent annual growth in real gross domestic product (GDP), growth in advertising and communications spending that outstripped GDP, and growth in financial accounts continuing to exceed growth in the number of households. *See* GREG SCHMID, TWO SCENARIOS FOR FUTURE MAIL VOLUMES, 2003-2017 6 (Inst. for the Future 2003), *filed as* Library Reference NALC-LR-N2010-1/4, PRC Docket No. N2010-1 (Aug. 3, 2010). Needless to say, the Great Recession confounded all of these macroeconomic assumptions. *See* United States Postal Serv., Initial Comments in Response to Commission Order No. 2540, PRC Docket No. R2013-11R (June 26, 2015), at 32 fn.59 (citing materials on the record in PRC Docket No. R2013-11).

Expressing the volume decline in absolute terms masks the extent of the problem. The biggest decreases have occurred, and will continue to occur, in First-Class Mail, the product that provides the greatest contribution to the Postal Service's institutional costs. As a result, the mail mix is becoming increasingly weighted toward lower-contribution products, particularly Marketing Mail. It takes roughly three additional pieces of Marketing Mail to compensate for the loss of a single piece of First-Class Mail, in terms of contribution.[176] The following chart shows the impact of this shift. When each class of mail is weighted according to its contribution relative to that of First-Class Mail, contribution-weighted volume peaked in FY2000, six years before the peak in total nominal volume. That volume thereafter declined gradually for the early part of the century (with a decline due to the 2001 recession and terrorist attacks, followed by an upswing), and then collapsed following the enactment of the PAEA.

[176] Library Reference USPS-FY16-1, FY2016 Public Cost and Revenue Analysis (PCRA) Report, Microsoft Excel file "Public_FY16CRAReport.xls," tab "Cost1," cells P28 & P35. Nor can competitive products make up the difference. Despite their higher unit contribution than First-Class Mail, competitive products are proportionally smaller, with total contribution to institutional costs only one-third that of First-Class Mail. *Compare id.* at tab "Cost1," cells D23 & F23, *with id.* at tab "Cost3," cells D22 & F22.

Chart 9: Total nominal, First-Class Mail-equivalent, and per-delivery-point volumes, FY1995-FY2016, in billions (FY1995=100)[177]



The chart also shows the decline in mail volume per delivery point, a critical metric for a network for which financial stability depends on economies of density. On both a nominal and First-Class Mail-equivalent (contribution-weighted) basis, total volume per delivery point peaked in FY2000 as well, was declining thereafter, and then saw a tremendous decline after the enactment of the PAEA. The Postal Service's economies

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[177] For purposes of this chart, delivery points do not include Post Office Boxes. Weights to calculate First-Class Mail-equivalent volume were determined by the average unit contribution for each mail category between FY1995 (or the earliest year of available data thereafter) and FY2016. For example, if the average unit contribution of Marketing Mail was one-third that of First-Class Mail during the period, then each Marketing Mail piece would count as one-third of a First-Class Mail-equivalent piece. The use of average weighting factors reduces the impact of year-over-year changes in unit contribution due to extraneous factors.

of density have therefore fallen at a far faster pace than either nominal or contribution-weighted volume figures would suggest, which further demonstrates the gap between the former assumptions of the current system's viability and the grave reality.

Due to the universal service obligation, the Postal Service must maintain a nationwide retail, processing, and delivery network to reach almost every address in America six days a week. This leads to a large amount of institutional costs. These costs grow in tandem with the inexorable growth in delivery points, rather than declining in tandem with volume. As a result, the dramatic volume declines of the PAEA's first decade translated into a significant loss in the Postal Service's economies of scale and density, which results in a significant increase in the average cost of each mailpiece even before inflation in input costs is taken into account. Unlike for some public utilities, there is no fixed service charge to access the mail delivery network and offset the Postal Service's network costs. The Postal Service's universal service network and sender-pays model therefore leave it exposed to substantial financial risk if volume growth does not keep pace with delivery point growth. And of course, it did not help that, atop rising network costs, the Postal Service is burdened with substantial annual payments to fund post-retirement benefits.

As the Commission has noted, "[t]he combination of the price cap and the continuing decline of First Class Mail prevents the Postal Service from generating sufficient funds from mail users to cover its institutional costs."[178] In particular, the price cap prevents the Postal Service from generating sufficient unit revenue from the mail

[178] Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2011 (Mar. 28, 2012), at 5; *see also* United States Postal Serv. Office of the Inspector Gen., RARC-WP-13-007, Revisiting the CPI-Only Price Cap Formula (2013), at 3-4 [hereinafter "OIG Price Cap Report"].

volume remaining in the system to account for the higher unit costs of that volume. The price cap is based on an index that measures general price levels in the economy, and it does not consider Postal Service volume changes, unit cost trends, or the fact that many of the Postal Service's costs rise at levels independent of the trends in consumer inflation.[179]

Not only did volumes decline much faster than was expected at the time the PAEA was enacted, but CPI dropped to historically low levels and even became negative during the Great Recession. Given that there had not been a comparable period of declining CPI in 40 to 50 years, there was little expectation when the PAEA was passed that CPI would be at historic lows for a sustained period of time.[180] While

[179] *See, e.g.*, Public Representative Comments, PRC Docket No. PI2016-3 (June 15, 2016) [hereinafter "Public Representative Section 701 Comments"], at 47-50; OIG Price Cap Report at ii-iii ("The Postal Service's financial viability under the price cap is highly dependent on mail volume. When the current price cap formula was enacted in 2006, postal volumes had been trending upward. Few analysts or policymakers foresaw the recent steep decline in mail volume, or contemplated the impact on the Postal Service of such a decline combined with the price cap. . . . The present price cap formula was not designed for an environment of falling mail volumes. An unstated assumption under a traditional price cap is that volume will remain stable or preferably grow. Growth in the output of products is likely needed to cover costs, particularly in the case of the Postal Service where the network of delivery points is expanding.") (internal cross-reference omitted)); Public Representative Comments in Response to Order No. 636, PRC Docket No. ACR2010 (Feb. 2, 2011), at 5 ("[R]evenue per delivery point decreased by 2.0 percent in FY 2010 due to volume declines. The Postal Service needs a new source of revenue [in addition to the price cap] to cover the increasing costs of new delivery points."); *H.R. 22, The Postal Reform Act of 1997: Hearing Before the Subcomm. on the Postal Serv. of the House Comm. on Gov't Reform and Oversight*, 105th Cong. 249-50, 259-60, 268 (1997) (statements of Dr. Laurits R. Christensen and Dr. William J. Baumol).

[180] Annual CPI growth went negative in 2009 (-0.32009 percent) for the first time since 1955 (-0.25684 percent). The average rate of annual CPI growth from the first full year of the Great Recession in 2009 to 2015 (1.38935 percent) is lower than in any other seven-year period since 1959-1965 (1.26084 percent). The similarity in averages belies a contrast between those two periods: CPI was low but steadily rising during 1959-1965, whereas it was both low and generally falling during 2009-2015. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items (CPIAUCSL), *retrieved from* Fed. Reserve Bank of St. Louis, https://fred.stlouisfed.org/graph/?g=cD4I (last visited Feb. 14, 2017); *see also* Postal Regulatory Comm'n, 12-Month Average Change in CPI-U (updated Feb. 15, 2017), https://www.prc.gov/sites/default/files/150217%20CPIweb.pdf (showing the 12-month rolling-average change in CPI-U remaining around 3 percent for pre-PAEA periods, but going negative in the periods ending in October 2009 through January 2010).

this helped the Postal Service in some respects, such as by reducing and even temporarily eliminating cost-of-living salary adjustments, significant cost inputs outside of the Postal Service's control continued to rise despite the overall decline in CPI.[181] The Postal Service was therefore unable to address those increased structural costs through price increases under the CPI price cap.

As discussed in section IV.A.4 below, the statute's exigency safety-valve provision could not make up the difference, since the Commission read the provision narrowly to effectuate Congress's intent about the primacy of the price cap (a statutory primacy that, as of this review, is no more). Thus, the exigency provision allowed an adjustment for only those effects that could be affirmatively tied to the Great Recession's level shift in mail volumes and that occurred during a limited period (in the end, only 19 percent of the volume decline between FY2008 and FY2012).[182] In short, the PAEA's CPI price cap and the limited exigency provision proved to be woefully

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[181] *See* Public Representative Section 701 Comments at 37, 46 ("The change in consumer prices is, at best, only remotely related to Postal Service operations cost changes. They bear little or no measurable relationship to funding requirements established for retirees by the PAEA. . . . Unless the change in the CPI-U Index mirrors reasonably the Postal Service's costs as controlled by honest efficient management, there will be a disconnect between the revenue received and total costs of the Postal Service. Experience since the PAEA was passed indicates the CPI-U has not been sufficiently flexible to respond to declining mail volumes brought about by losses of First-Class Mail volume to the internet, a recession, as well as declining mail density.").

[182] Order No. 1926 at 60-106; *see also* Order No. 864 at 35-39, 42, 48 (limiting the basis for recovery to only those volumes that could be tied to the exigent circumstance).); *see also* Public Representative Section 701 Comments at 37-38 (describing the exigency provision as an "extremely limited opportunity for . . . rate relief," in contrast to the lack of any provision in the current system "requiring recovery of all institutional costs apportioned to market dominant products"). *Compare* Order No. 2623, Order Resolving Issues on Remand, PRC Docket No. R2013-11R (July 29, 2015), at 32, 45, 54 (allowing recovery for 35.088 million pieces of market-dominant mail lost due to the Great Recession), *with* Initial Comments of the United States Postal Service in Response to Commission Order No. 2540, PRC Docket No. R2013-11R (June 26, 2015), at 31 (describing the aggregate net market-dominant volume loss between FY2008 and FY2012 as 183.5 billion pieces).

inadequate to the task of aligning costs and revenues, considering the precipitous volume declines that have occurred since the PAEA was enacted.

As Christensen Associates note in Appendix E, in order to produce successful outcomes, any price cap system must reflect the expected changes in unit cost of the entity or entities being regulated, and include measures to ensure that the cap formula can appropriately accommodate changing circumstances.[183] In this way, workable price cap systems are designed to realistically balance policies of incenting efficiency and maintaining a firm's financial integrity, by applying achievable efficiency incentives while at the same time ensuring compensatory rates and the firm's continued ability to provide quality service.[184] In both respects, the current system has proven to be poorly designed: the CPI-U price cap has failed to reflect changes in Postal Service unit costs, and the sole safety valve is extremely limited.

2. The current system has failed its objective of yielding adequate revenues to ensure financial stability (Objective 5).

Although Congress ultimately adopted a different approach when it enacted the PAEA for the initial system, an earlier Senate committee was prescient in its warning that "[r]eplacing one inflexible system with another will not address the needs of the postal community or ensure long-term survival of the American public's postal

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[183] Appendix E at 31-35.

[184] *See, e.g.*, In the Matter of Policy and Rules Concerning Rates For Dominant Carriers, 5 F.C.C. Rcd. 6786 (Oct. 4, 1990) (discussing the balancing that occurs in the design of a price cap regime to achieve statutory polices, including the need to ensure that a "price cap formula [does not] stray so far from actual costs that the cap will produce unreasonably low rates"); In the Matter of Policy & Rules Concerning Rates for Dominant Carriers, 4 F.C.C. Rcd. at 2878 (noting that a "workable" price cap formula is one that is "designed to ensure a continuing nexus between tariffed rates and the underlying costs of providing service."). The legislative history of the PAEA also demonstrates an awareness of this fundamental balance in appropriate price cap design. *See also* S. REP. NO. 108-318, at 10 (noting that price cap system designed by Commission "should provide for the maximum possible pricing flexibility while maintaining adequate financial safeguards and incentives for cost control.").

system."[185] As the Commission has noted, the "erosion of retained earnings" that the Postal Service has experienced during the current system translates into a "deterioration in the Postal Service's viability."[186] The same Public Representative as in this proceeding recently offered an even more pointed assessment:

> Capped market dominant rates cannot be adjusted to assure adequate revenues in order to return to financial stability, except in very limited circumstances not now available, for current critical financial needs.
>
> To be sure, there are objectives listed in the PAEA that suggest recovery of total costs, including institutional costs, when establishing market dominant rates[, such as Objective 5]. . . . Section 3622(b) states that the objectives of the modern system for regulating rates and classes for market-dominant products shall be designed to achieve the list of all 9 objectives. However, these objectives have been held to be subservient to the price cap requirement in section 3622(d)(1)(A) that necessarily has led to revenue shortages and the narrow terms of the financial relief valve in section 3622(d)(1)(E) strictly limiting qualification for exigent rate increases, although rate increases are otherwise necessary. . . .
>
> [T]he Postal Service's economic circumstances have continued to deteriorate, notwithstanding a slow and limited improvement over the last five years as operations, aided by the temporary exigent surcharge, posted some profits. The Postal Service remains in precarious financial straits and, to say the least, faces a challenging financial future.
>
> In addition to the problems presented by the requirement of lump-sum PSRHBF payments, the exhaustion of Postal Service's borrowing authority, and the termination of the exigent surcharge, the Postal Service's financial viability will be further hampered by the way the price cap operates in an environment in which mail volumes are decreasing and the number of delivery points is increasing.[187]

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[185] S. REP. NO. 108-318, at 8. The Senate committee's version of the PAEA would have been materially less rigid than the final, enacted version: for example, the Commission would have had discretion from the outset to craft a rate-regulatory system "based on" any of a number of inflation indices, and exigent increases would have been subject to fewer limiting criteria. *See id.* at 100-101.

[186] FY2014 Financial Analysis Report at 68.

[187] Public Representative Section 701 Comments at 38-39, 45 (footnote omitted); *see also* Public Representative Reply Comments in Response to Advance Notice of Rulemaking, PRC Docket No. RM2017-1 (Mar. 9, 2017), at 9 ("This limit [i.e., the price cap] has led to huge Postal Service losses while market dominant products have been set at their full price cap limit under the PAEA.").

The OIG agrees: “The [Postal Service’s] financial situation [under the price cap] is a threat to the provision of universal postal service, the traditional cornerstone of postal policy.”[188] So does GAO: “[The Postal Service] continues to face a serious financial situation with insufficient revenues to cover its expenses, putting its mission of providing prompt, reliable, and efficient universal services to the public at risk. . . . USPS’s financial condition continues to deteriorate and remains on our High-Risk List.”[189]

This consensus is correct. Contrary to Congress’s expectations, the CPI price cap, in combination with a limited exigency safety valve, has not allowed the Postal Service to cover all of its costs and retain earnings notwithstanding the fact that the Postal Service has aggressively reduced costs and increased efficiency. The result is that the Postal Service has not had adequate liquidity for contingencies, mandatory payments, or capital investment needs.[190] Continuing the current CPI price cap regime would only condemn the Postal Service to further instability under the weight of its legal mandates and its now-known structural headwinds. As Objective 5 makes explicit, Congress passed the PAEA to sustain the Postal Service, not to destroy it, and the

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[188] OIG Price Cap Report at IV.

[189] GAO, GAO-17-404T, U.S. Postal Service: Key Considerations for Restoring Financial Sustainability (2017), at 1.

[190] *E.g.*, FY2014 Financial Analysis Report at 23-24 (“[T]he Postal Service has undertaken only limited capital investments in the last 4 years due to its lack of available working capital. This has hindered growth and productivity enhancements in key infrastructure assets required for primary postal operations. . . . Capital investments in physical resources are necessary to increase and maintain productivity. For the Postal Service to effectively compete in the e-commerce market, it will need to make capital investments in suitable delivery vehicles. It also needs to replace its existing aging vehicles to accommodate the shift in mail mix toward a larger share of packages relative to letter- and flat-shaped pieces of mail. The Postal Service must also invest in new and efficient mail processing technologies and equipment. However, its ability to make these investments is diminished by the lack of available working capital.”); *see also* GAO, GAO-14-155, U.S. Postal Service: Actions Needed to Strengthen the Capital Investment Process (2014), at 2 (“USPS’s limited resources have constrained its funding for capital investments to fulfill its primary mail-delivery mission and restructure and modernize its operations.” (footnote omitted)).

Commission must evaluate the rate-regulation system in a way that is consistent with the legislative plan.[191]

The Postal Service's cumulative net losses, limited liquidity, and serial defaults on statutory obligations mean that "[t]he USPS is not currently financially stable . . . because it does not cover its costs and is not expected to be in a position to cover its costs in the foreseeable future."[192] As described in section III.B.1 above, Evercore concludes that "financial stability" is best understood to mean sufficient revenue and retained earnings to fund annual operating expenses, statutorily mandated payments (including all post-retirement benefits), debt service, and a prudent level of capital investment, and to provide a cushion against short-term risks.[193] Evercore also sets forth three "pillars" of financial stability, and assesses the Postal Service's current situation against comparable entities (including foreign postal operators). The Postal Service falls far short in each of the categories, as well as far short of Evercore's recommended targets.[194] For example, Evercore's benchmark analysis shows that a positive EBT margin is key to financial stability (in that it is the means by which the Postal Service can address all aspects of financial stability); indeed, when the Postal

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[191] *See* King v. Burwell, 576 U.S. __, 135 S. Ct. 2480, 2496 (2015) ("A fair reading of legislation demands a fair understanding of the legislative plan. Congress passed the Affordable Care Act to improve health insurance markets, not to destroy them. If at all possible, we must interpret the Act in a way that is consistent with the former, and avoids the latter.").

[192] Appendix B at 12.

[193] *Id.* at 10.

[194] As noted above, the Postal Service does not necessarily endorse Evercore's recommended numerical targets. Whatever room for argument might exist with respect to the specific target levels, however, it cannot be ignored that the Postal Service is far below any reasonable conception of financial stability according to these metrics.

Service entered the PAEA, its EBT margin was positive (1 percent).[195] After a decade of the current system, however, the Postal Service's FY2016 result was negative 8 percent.[196]

These findings align with what the Commission itself has recognized in the past. In its Annual Report to the President and Congress for Fiscal Year 2013, the Commission discussed the "effectiveness of the Commission's rules to achieve objectives of the PAEA," including "maintaining adequate revenue." The Commission discussed the Postal Service's net losses stemming from volume declines, a changing mail mix, and limited ability to cut costs, and noted that the meager pricing flexibility available under the law could not "generate[ ] enough revenue or contribution to recover the losses from volume declines."[197] A similar assessment in the prior year was even more blunt:

> The Postal Service's current financial challenges demonstrate that it is at risk of failing to meet [Objective 5]. . . . Despite the Postal Service's efforts to significantly reduce costs, the revenue generated from these increases has not been enough to cover the funding requirements and operating expenses. In FY 2012 the average revenue per piece was 40.8 cents. For the Postal Service to break even, the average revenue per piece would have to increase to 50.8 cents. This equates to a 24 percent average increase in revenue per piece. To cover only operating costs, without the RHBF payment, a seven percent increase in revenue would have been necessary to break even. The actual CPI-U capped average rate increase was 2.133 percent. . . . The continued losses in revenue

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[195] United States Postal Serv., Form 10-K for FY2007 (2007), at 10 (showing FY2006 net income of $900 million and total revenue of $72,817 million).

[196] United States Postal Serv., Form 10-K for FY2016 (2016), at 12 (showing a FY2016 net loss of $5,591 million and total revenue of $71,498 million).

[197] Postal Regulatory Comm'n, Annual Report to the President and Congress, Fiscal Year 2013 (Jan. 9, 2014), at 20-22.

> may seriously hamper the Postal Service's ability to pay for basic operations in the very near future.[198]

Even earlier, when the Commission initially declined to allow relief from the price cap on account of the Great Recession, the Commission went to great lengths to contrast the "liquidity crisis" that the Postal Service has suffered since the PAEA against "the important role of retained earnings in postal reform."[199]

The Commission's task in 2010 was limited. It was considering a request for extraordinary relief, pursuant to specific statutory conditions, as a narrow exception to the then-mandatory rule of the price cap. Today, however, the Commission's authority and responsibility are broader. The price cap and other aspects of the initial regulatory system are no longer a given. As the Commission, the Public Representative, the OIG, GAO, and expert analyses by Christensen and Evercore demonstrate, the current system has failed to allow the Postal Service to generate revenues adequate to meet reasonable benchmarks of financial stability.

3. The current system has failed to provide compensatory rates for market-dominant products (Objectives 8 and 9).

As discussed in section III.B.1 above, "just and reasonable rates" is a term of art in rate-regulation contexts: rates must enable the regulated entity, exercising prudent management, to maintain its financial integrity, but they must not yield excessive profits. The current system's impacts demonstrate that it has failed to provide compensatory rates, and therefore to be just and reasonable. In addition, as discussed in section

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[198] Postal Regulatory Comm'n, Annual Report to the President and Congress, Fiscal Year 2012 (Jan. 3, 2013), at 27-29.

[199] Order No. 547 at 70-78. In that order, the Commission attributed the liquidity crisis primarily to the statutory RHB prefunding schedule. However, the Commission later recognized that the existence of this schedule did not provide a basis to deny exigent relief for the volume lost due to the Great Recession..

III.B.4 above, the current system has also failed to allow market-dominant products to ensure that total institutional costs are covered, even with contribution from competitive products in excess of those products' "appropriate share." As a result, the current system has failed to achieve both Objectives 8 and 9.[200]

As described in sections IV.A.1 and .2 above, the current system has failed to cover the Postal Services' total costs (including institutional costs), let alone provide a reasonable measure of retained earnings to maintain financial stability.[201] The Postal Service's current ability to cover its total costs, as well as its future ability to sustain universal service, must not be sacrificed on the altar of low or stable rates. This principle has long been recognized in Commission practice:

> If . . . rates [are held] below costs, then current users fail to pay the full costs of operating the Postal Service. Debt is incurred to fund operating losses. This debt must eventually be paid off, which means that future users of the Postal Service will subsidize current users by paying first the interest on the debt, and then the principal. If the Service winds up in a position where it cannot reasonably repay its debt, then future taxpaying citizens of the United States will wind up subsidizing current users of the Postal Service.[202]

Far from striking a "just and reasonable" balance, the current system's benefits have been skewed too far toward unsustainably low rates, and too far against the Postal Service's financial integrity, to be "reasonable."

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[200] "[R]ecovering some additional revenue from competitive products would not solve the Postal Service's financial difficulties." Public Representative Reply Comments in Response to Advance Notice of Rulemaking, PRC Docket No. RM2017-1 (Mar. 9, 2017), at 10.

[201] Public Representative Section 701 Comments at 38-39, 43 ("[T]hese objectives [aimed at recovery of total costs, such as Objective 8,] have been held to be subservient to the price cap requirement in section 3622(d)(1)(A) that necessarily has led to revenue shortages and the narrow terms of the financial relief valve in section 3622(d)(1)(E) strictly limiting qualification for exigent rate increases, although rate increases are otherwise necessary. . . . Under the PAEA's price cap regime, since price caps were implemented, rates subject to the price cap limitation have not been allowed to be set high enough to cover the Postal Service's realized costs.").

[202] Op. & Rec. Dec., PRC Docket No. R94-1 at ¶ 2088.

The financial problems have overwhelmed even postal management's substantial and continuing efforts to reduce costs and increase productivity. As discussed in section IV.A.5 below, there is nothing material to be gained from second-guessing the prudence of management's decisions in controlling costs. In the past, the Commission has recognized postal management's exercise of honest, efficient, and economical management and has resisted attempts to claim that "the Postal Service's management practices have rendered an exigent rate increase unnecessary or less necessary to enable the Postal Service to maintain and continue the development of needed postal services."[203] Indeed, even "past determinations by the Postal Service to forgo cost-cutting opportunities (such as converting from door delivery or reducing the size of the workforce) in order to maintain needed postal services or comply with other legal obligations d[id] not, by themselves, render an exigent rate adjustment unnecessary or less necessary."[204]

Although the immediate context for those Commission remarks was the 2014-2016 exigent price increase, the essence is that the Postal Service has been adhering to its obligation under the PAEA to cut costs and increase efficiency, such that the persistence of its financial distress demonstrates the inability of simply "living within the price cap." That approach and conclusion retains its force in the immediate context as well. However much parties might quibble with specific decisions that postal management did or did not take, that exercise amounts to searching the couch cushions for loose change in hopes of staving off a home foreclosure. As the A&M Report in

[203] Order No. 1926 at 131; *see also id.* at 125, 128.

[204] *Id.* at 136.

Appendix C shows, the efficiency opportunities that currently remain in management's control come nowhere close to closing the projected ten-year operating deficit or enabling financial stability.[205] The big picture is that the current price cap system has simply failed to achieve the objectives that Congress set for it.

4. The exigency provision's limitations only heighten the inadequacy of the current system vis-à-vis Objectives 5 and 8.

The current system consists of two primary features: the price cap and the safety valve for "extraordinary or exceptional" (often termed "exigent") circumstances. A flexible price cap capable of adjusting to unforeseen circumstances and other market pressures might need only a narrow safety valve, whereas a rigid price cap without such leeway might warrant a more flexible safety valve. However, the current system is characterized by both a rigid price cap and a narrow exigency provision.

By its own terms, the exigency provision contains numerous limitations on above-inflation price adjustments. They must be triggered by "either extraordinary or exceptional circumstances"; the relief sought must be "due to" those circumstances; and the relief must be "reasonable and equitable and necessary to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States."[206]

The only occasion to test this provision has been in response to the Great Recession. The resulting Commission rulings revealed three significant limitations on

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[205] *See* section IV.F.2.c *infra*.

[206] 39 U.S.C. § 3622(d)(1)(E).

the exigency provision. First, the exigency provision does not allow the Postal Service to be restored to solvency; losses must be "due to" the exigent event, rather than to other causes.[207] Second, recovery is only allowed for those losses that the Postal Service can affirmatively prove are solely "due to" the exigent event, and not for those losses that might be attributable to it.[208] Third, the right to recovery ceases when the Postal Service has reached a "new normal," as determined by "all or most" of a four-factor balancing test (e.g., when the Postal Service has begun to take steps to the exigent event).[209] Thus, even if volume losses caused by an exigent event do not return, the Postal Service cannot be compensated for those continuing losses.

In the case of the FY2014-FY2016 exigent price adjustment, the combined effect of these limitations was to limit the Postal Service's recovery to less than one-fifth of its total FY2008-FY2012 volume losses. Losses that were deemed to be due to non-recession causes were excluded, as were losses coinciding with the Great Recession for which the Postal Service was unable specifically to exclude the possibility of being due to internet diversion. Finally, the Commission determined that each class of mail reached a "new normal" at different times between FY2010 and FY2012, and recovery was not allowed for losses after each cutoff. This meant that the surcharge was temporary. The end result was that the exigent provision could not allow the Postal

[207] Order No. 1926 at 22, 61; *see also* Order No. 1926, Separate Views of Commissioner Acton at 1 ("[T]he Postal Service may [not] lawfully move to address unrelated structural concerns by way of a tool ill-suited to the task – the extraordinary or exceptional circumstances rate adjustment.").

[208] Order No. 1926 at 63-83; *see also* Alliance of Nonprofit Mailers v. Postal Regulatory Comm'n, 790 F.3d 186, 195, 196 (D.C. Cir. 2015); Order No. 1926, Separate Views of Commissioner Acton at 3-4; Order No. 1926.

[209] Order No. 1926 at 83-94; *see also Alliance of Nonprofit Mailers*, 790 F.2d at 193-94; Order No. 2623, Order Resolving Issues on Remand, PRC Docket No. R2013-11R (July 29, 2015), at 23-28. .

Service to address the full effects of volume declines that have occurred since the PAEA.

Therefore, not only was an inflation-based price cap inadequate to the task of providing compensatory rates and adequate revenues to ensure financial stability, the exigency provision that Congress provided in the PAEA was likewise inadequate to making up the difference. These two central features of the current system, working in concert, have failed to provide compensatory rates and adequate revenues to ensure financial stability.

5. Not even aggressive management action could compensate for the failings of the current regulatory system.

Amid a near-decade of financial distress, the Postal Service has not sat idle and pinned its hopes on regulatory reform. To the contrary, it has acted responsibly and aggressively to reduce costs, improve efficiency, and grow revenue to the extent possible under the current system.[210] However much some commenters might second-guess them, postal management's business decisions demonstrate that it has fulfilled its duty under the PAEA to cut costs and increase efficiency through the exercise of prudent management, and there is no basis to suppose that the Postal Service's troubles are a product of mismanagement rather than of a failed rate-regulation system.

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[210] Appendix D at 7 ("Critics of the Postal Service might argue that the Postal Service's financial losses over the past ten years were due to relatively poor performance, but this is simply not true. The Postal Service has been able to grow TFP in a sustained fashion since 2000, due to reductions in resource usage. The Postal Service continued this productivity growth over the past ten years, even as workload has declined.").

a. Postal management has been unstinting in its efforts to control costs and grow revenues within its control.

Within its sphere of control, postal management has been tireless in responding to the financial pressures of the Postal Service's declining-volume environment to reduce costs and increase efficiency. The litany of management actions (many of which have been achieved in partnership with collective bargaining organizations) should be familiar to the Commission by now. The Postal Service has moved to rationalize its retail, processing, and delivery networks to account for excess capacity. Through collective bargaining agreements and arbitration awards, it has achieved significant reductions in labor costs, through the establishment of two-tier wage schedules, increased complements of non-career employees, reduced employer contributions to health benefits, and curve-bending adjustments to salary growth and cost-of-living adjustments.[211] Such efforts as "right-siz[ing] operations, increas[ing] workforce flexibility, and establish[ing] a more affordable, two-tiered wage system . . . have resulted in cost savings of approximately $14 billion annually."[212] Furthermore, the Postal Service has reduced both total staffing levels and work-hours by approximately 20 percent over the last decade.[213] The chart below illustrates a sample of the cost-control measures that postal management has undertaken over the past decade.

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[211] *E.g.*, Appendix C at 10-12; Renewed Exigent Request of the United States Postal Service in Response to Commission Order No. 1059, PRC Docket No. R2013-11 (Sept. 26, 2013) [hereinafter "USPS Renewed Exigent Request"], at 22-27; Reply Comments of the United States Postal Service, PRC Docket No. R2013-11 (Dec. 6, 2013) [hereinafter "USPS Exigent Reply Comments"], at 93-94, 100-105.

[212] Brennan Testimony at 2.

[213] Appendix C at 11.

Table 1: Selected effects of key postal management cost-control decisions, FY2006 vs. FY2016[214]

COST CONTROL MEASURES: 9/30/2006 - 9/30/2016

		Count		% Change
Infrastructure	Consolidated Mail Processing Facilities	360	↓	54%
	Delivery Route Consolidations	20,000	↓	9%
	Post Offices with Reduced Retail Hours	13,000	↓	36%
Workforce	Work Hours (annual ongoing)	301M	↓	21%
	Career Employees	187,000	↓	27%
	Non-Career Employees	31,000	↑	31%
	Total Employees	156,000	↓	22%
	Administrative Positions	25,000	↓	33%
Administration	Number of Administrative Areas	9 to 7	↓	22%
	Number of Districts	80 to 67	↓	16%

The fruits of these efforts are reflected in the Postal Service's productivity measures, as discussed in section IV.C below.

The aggressiveness with which the Postal Service has sought out efficiency gains is illustrated by the fact that it has been ranked as the most efficient postal operator in the industrialized world.[215] Indeed, as discussed in section V.B.1 below,

[214] Brennan Testimony at 5.

[215] Oxford Strategic Consulting (OSC) performed a comparative study in 2012 that reached this conclusion, but that study is not publicly available. *See* USPS Renewed Exigent Request at 24. In 2016, the Postal Service asked OSC to update its earlier study, and OSC found that the Postal Service's operational efficiency ranking remains unchanged. The updated study is publicly available. OSC Oxford Strategic Consulting, Delivering the Future 2016: How the G20's Postal Services Are Meeting the Challenges of the 21st Century 5-6, 8-9, 33, 37, 39-40 (2017), http://www.oxfordstrategicconsulting.com/wp-content/uploads/2017/03/Delivering-the-Future-of-the-Postal-Service-in-the-G20-Final-Report-March-2017.pdf.

Although some have mischaracterized a 2013 study by Accenture as supposedly taking the opposite position on the Postal Service's relative efficiency, Declaration of Dennis W. Carlton, PRC Docket No. RM2017-1 (Mar. 3, 2017), at 10, that study actually ranks postal operators only in terms of business performance, not operating efficiency. Brody Buhler et al., Achieving High Performance in the Postal Industry: Accenture Research and Insights 2013 (Accenture 2013), at 4 (describing the "traditionalist" category, which included the Postal Service, as "focused on improving the efficiency of the mail," as opposed to diversifying, and as "lagging" in terms of "revenue growth" and the negative effects of volume declines, "tighter regulations," and "employee spread"). If anything, the Accenture study supports the conclusion in this section that the Postal Service has made responsible strategic decisions

Postal Service management has been at the forefront of postal operators – and has even been ahead of liberalized and privatized operators – in pursuing automation. At the same time, the Postal Service has been successful in harnessing a burgeoning e-commerce market to foster competitive products' growing contribution to institutional costs.[216]

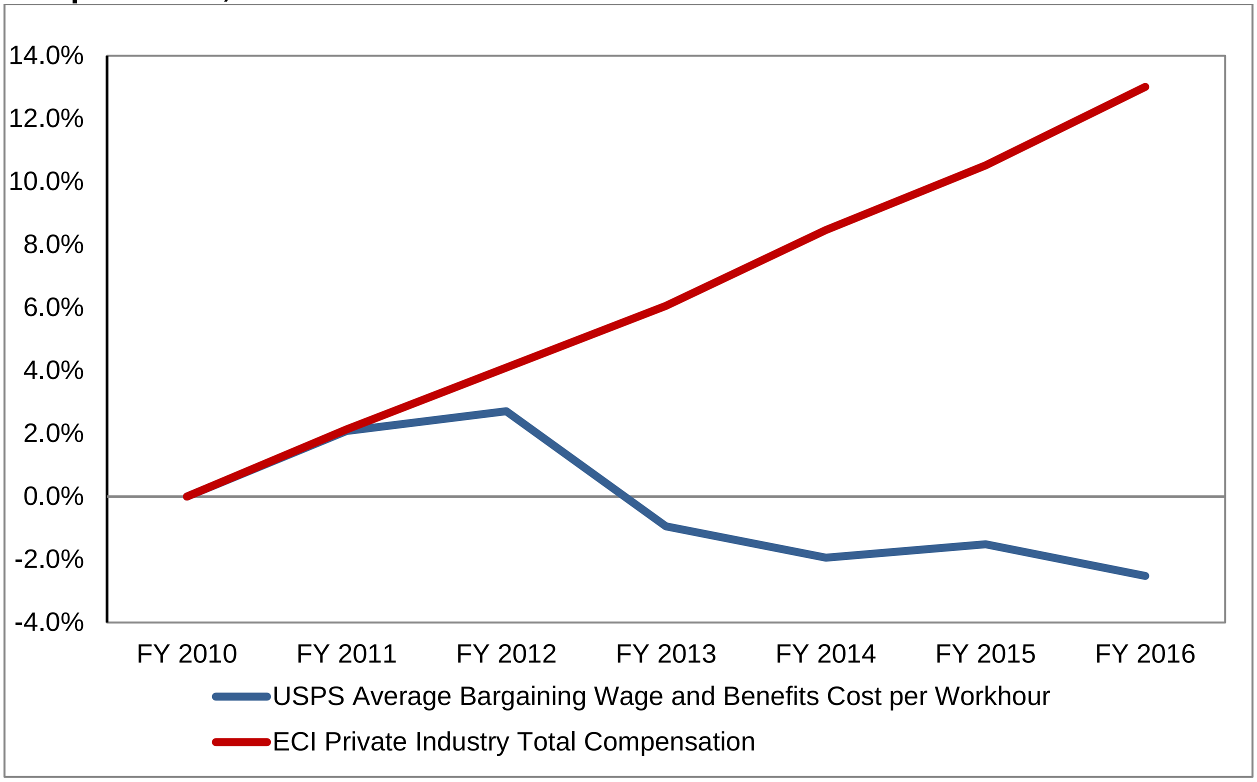
In addition to improving efficiency and reducing work-hours, the Postal Service and its labor organizations have reached new collective bargaining agreements that have reduced average hourly compensation. These reductions are particularly striking in contrast with the inflation of wages and benefits in the general economy. The chart below compares the two trends starting in FY2010, the last full year that all of the pre-recession collective bargaining agreements were still in effect.[217]

despite its constraints, *see id.* at 10 (praising the Postal Service as a "high performer" for its innovation concerning mobile barcodes on direct mail), as well as the broader conclusion that current system is not enabling the Postal Service to achieve a reasonable standard of financial stability compared with other, higher-performing postal operators.

[216] *See* Initial Comments of the United States Postal Service, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 11-12, 18; FY2015 Financial Analysis Report at 40-42. Amid changes in the e-commerce marketplace, however, competitive products' contribution cannot be expected to grow indefinitely. *See* Initial Comments of the United States Postal Service, PRC Docket No. RM2017-1, at 14-17.

[217] The Postal Service negotiated four major labor agreements in FY2006 and early FY2007. The last full fiscal year of two of those agreements was FY2010; it was FY2011 for the other two. Thus, the first agreement concluded after the Great Recession began to take effect during FY2011. Arbitration awards for the other three agreements were issued during FY2012 and FY2013.

Chart 10: Growth in average Postal Service and private industry total compensation, FY2010-FY2016[218]



Some might try to make hay out of such questions as whether postal management should have been more aggressive on centralized delivery, real estate sales,[219] underwater products,[220] or labor negotiations, or whether it should have been less aggressive about some investment or other, such as the Flats Sequencing System

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[218] Average Postal Service bargaining-unit compensation per workhour is drawn from the National Payroll Hours Summary Report for the final pay period of each fiscal year (generally Pay Period 20). Total compensation for private industry is drawn from the Employment Cost Index. Bureau of Labor Statistics, Data Series ID CIU2010000000000I, Total Compensation for Private Industry Workers (extracted Mar. 16, 2017). *See also* Appendix C at 10 & fn.24.

[219] *See* Motion of MPA—The Association of Magazine Media and Alliance of Nonprofit Mailers for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 6, 2017), at 6. For a more detailed response to such an argument, see Opposition of the United States Postal Service to Motion for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 10, 2017), at 15-17.

[220] *See* section IV.D.1 *infra*.

(FSS).[221] However, the Commission has rightly recognized that second-guessing business decisions at the margins is not a basis to ignore the larger issue of whether the rigid price cap is failing despite postal management's efforts to cut costs and increase efficiency.[222] Postal management must often weigh a number of factors when making decisions that affect costs, and the Commission has appropriately accorded management deference in doing so.[223] Far from blaming the Postal Service's woes on any deficiencies in cost-cutting, the Commission has repeatedly found that the Postal Service had done a "commendable job" at exercising "honest, efficient, and economical management" to reduce costs.[224]

b. Postal management's decision to forgo a last cost-of-service rate case was prudent, not imprudent.

Finally, some might grasp at a straw even farther down in the pile: the fact that the Postal Service did not file a transitional last rate case under the pre-PAEA rules

[221] The Postal Service expects that some commenters might point selectively to increases in unit attributable costs for flats that followed the introduction of FSS. *See* Motion of MPA—The Association of Magazine Media and Alliance of Nonprofit Mailers for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 6, 2017), at 7. However, such an argument would not necessarily account for savings in institutional costs from FSS (e.g., through the Postal Service's enhanced ability to optimize delivery routes), or the extent to which the coinciding attributable cost increases might be explained by other factors.

[222] *See* Order No. 1926 at 131, 134-35 ("Unlike a private enterprise, the Postal Service must consider the impact of its cost-cutting activities on its ability to continue to provide postal services consistent with the policies of title 39, United States Code. . . . That further opportunities for cost reductions in this area exist is not sufficient to persuade the Commission that reducing costs in this area would eliminate the need for an exigent rate increase. Although converting from door delivery might reduce costs, Valpak has not shown that converting from door delivery would also allow the Postal Service to maintain and continue to develop postal services of the kind and quality adapted to the needs of the United States.").

[223] To use the issue in the previous footnote as an example, postal management has had to weigh "the negative impact on volume, customers, and communities, the likely intensity of public and political resistance, and the substantial implementation costs" in its decisions about the pace of delivery mode conversions. USPS Exigent Reply Comments at 104-105.

[224] Order No. 547 at 61 fn.48, 80-86; *see also* Order No. 1926 at 131-36, 142-143 (noting that the Postal Service had demonstrated "an ongoing good faith effort to improve [its] financial condition" though its cost reduction initiatives).

during the first year of the PAEA, as the PAEA allowed.[225] Specifically, this argument might posit that the Postal Service missed an opportunity to true up rates on account of the PAEA's new RHB prefunding obligation, which was not accounted for in the actual last rate case.[226] However, it was entirely reasonable for the Postal Service not to do so, in light of four key factors.

First, at the urging of various stakeholders, the Commission accelerated its proceeding to establish the new ratemaking system specifically to "obviate the necessity for rate relief through an omnibus rate case under existing procedures."[227] The Commission also noted that it would be "unfortunate" for the Postal Service to file a last rate case.[228] Therefore, at the time, there was a broad consensus that a last rate case should not be filed.

Second, the notion that a last rate case was necessary to build the RHB payments into the rate base does not account for the changes made by the PAEA to the Postal Service's post-retirement benefits expenditures. While the rate base for a last rate case would have included the RHB payments, it would have had to exclude the CSRS escrow expense and actuarial payments that had formed part of the rate base in

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[225] *See* 39 U.S.C. § 3622(f); *see* Public Representative Comments, PRC Docket No. PI2016-3 (June 15, 2016), at 37 ("Such a rate case would have established a higher rate floor for future rate increases tied to the CPI-U.").

[226] *See* Op. & Rec. Dec., PRC Docket No. R2006-1 (Feb. 26, 2007), at 19-20.

[227] Order No. 26 at ¶ 1003. After the current system was established, the then-Chairman touted the Commission's speed in doing so and credited it with "result[ing] in the Postal Service foregoing [sic] one final rate case under the old law." *Implementation of the Postal Accountability and Enhancement Act of 2006: Hearing Before the House Subcomm. on Fed. Workforce, Postal Serv., & the District of Columbia*, 110th Cong. 84 (Feb. 28, 2008) (statement of Dan G. Blair, Chairman, Postal Regulatory Commission).

[228] Order No. 26 at ¶ 1003.

Docket No. R2006-1, and which were eliminated by the PAEA. The net effect probably would not have justified a significant price increase.

Third, contemporaneous volume projections would not have predicted actual volumes in the test year, and hence would also not have supported a significant price increase. Given the May 2007 implementation of the Docket No. R2006-1 price increases and the timing of peak season, the Postal Service likely would have waited to file a last rate case until December 2007. The case would have taken until September 2008 to resolve, and prices might not have been implemented until shortly thereafter. At no time during the rate case would the tempest of the Great Recession have appeared on the horizon, much less its devastating effect on mail volumes. To the contrary, the Postal Service and the Commission would have expected rising volumes to yield sufficient revenue to cover costs (and the small contingency that would have been presumed necessary)[229] with only a moderate price increase. These prices would have offered little solace when volumes fell off a cliff during the Great Recession.

Finally, the Postal Service would have missed an even bigger opportunity by forgoing the first two CPI adjustments. In October 2007 – before the Postal Service would have initiated the last rate case – the Commission ruled that, in the event of a last rate case, the new CPI-based price adjustment authority would not begin to accrue until the Governors approved the rates.[230] Thus, if the Governors approved the rates from a last rate case in the fall of 2008, CPI-based pricing authority would not begin to accrue

[229] In Docket No. R2006-1, the Postal Service and the Commission deemed adequate a contingency of only one percent of projected total costs for Test Year FY2008, and at least some mailing industry organizations thought even that was excessive. Op. & Rec. Dec., PRC Docket No. R2006-1, at 15-18.

[230] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at 54-55, 126.

until that time. By then, of course, the Great Recession had begun, and CPI was negative during FY2009, when the Postal Service would have been faced with a first price filing under the new rules. By not exercising the last-rate-case option, the Postal Service was able to use the new price cap to raise prices by 2.9 percent in May 2008 and by another 3.8 percent in May 2009. It was also able to benefit from the value of these price increases before volumes declined.

B. The Failure to Produce Adequate Revenues Undermines Other Objectives, Such as Maintaining High Quality Service and Enhancing Mail Security (Objectives 3 and 7).

If a faulty engine threatens to crash a plane, then it goes without saying that the plane will not be able to maintain high quality of service in the future. Similarly, the price cap's peril to the Postal Service's very existence throws into question future generations' ability to receive high-quality postal services.

In the near term, the constraints of the price cap system mean that financial relief can come only through cost savings, which has the potential to negatively affect service. The Postal Service has and will continue to examine the appropriateness of adjusting its service levels in order to rationalize its networks with declining demand; for example, in order to free up opportunities to consolidate the network, the Postal Service scaled back overnight First-Class Mail and Periodicals service and expanded many two- and three-day delivery ranges. This was a necessary response to excess capacity caused by volume declines, and it is an example of how volume pressures incentivize efficient management decisions regardless of the price cap.[231]

[231] *See* section IV.C *infra*.

However, the Postal Service's financial pressures also drove it to accelerate related operational changes, such as changes in the operating window and other resource realignments. As the Commission is well aware, these changes led to declines in reported service performance in FY2015.[232] The Postal Service has since managed to "significantly rebound" from its FY2015 service challenges and has achieved record service performance levels in key categories.[233] However, the experience underscores the point that, by putting the Postal Service in a state of perpetual financial distress, the price cap has forced – and, if maintained, will likely continue to force – moves that could come at the potential expense of service quality.

In addition, if, in an era of continuing volume declines, the price cap continues to jeopardize the Postal Service's ability to garner retained earnings, it will likewise deprive the Postal Service of the capital needed to make investments in infrastructure and enable it to sustain high-quality service, such as new vehicles, software, and equipment. As noted in section IV.A.1.a above, since the PAEA, the Postal Service has deferred or reduced almost $10 billion dollars in needed capital investments, notwithstanding the

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[232] Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2015 (Mar. 28, 2016) [hereinafter "FY2015 ACD"], at 133-37; *see also* Public Representative Section 701 Comments at 39-40 (linking "[t]he Postal Service's financial stress" to "cost savings initiatives" and to "[r]educed service performance scores for FY2015," which "are indicative of the after-effects of financial stress" and "an outgrowth of the limitations on Postal Service revenue since the PAEA was passed").

[233] U.S. POSTAL SERV., FY2016 ANNUAL REPORT TO CONGRESS 16 (2016); *see also* United States Postal Service, FY2016 Annual Compliance Report, PRC Docket No. ACR2016 (Dec. , 2016), at 69 ("Not only have the Postal Service's service improvements been broad across almost all product categories, but its achievements have also been dramatic in magnitude, particularly in certain important categories. For First-Class Mail, the Postal Service's composite performance in FY 2016 is now higher than it was prior to the time that the operating window change was implemented. For Marketing Mail, the Postal Service achieved its highest ever annual composite performance, attaining an annual FY 2016 composite performance of 93.0 percent. That was not only the highest annual figure ever achieved, but it also exceeded its target of 91.0 percent by two percentage points. These composite results were driven by great leaps within most component categories.").

higher maintenance costs and service challenges that old equipment, information technology, and vehicles have imposed in the interim.

In allowing a limited deviation from the price cap within the constraints of the current exigency provision, the Commission recognized that allowing the Postal Service to generate additional revenues above the cap, and hence to improve its financial position, would best serve Objective 3.[234] This implicitly acknowledges that rigid adherence to the price cap has not served to further the objective. Although the limited departure of the exigent surcharge provided a measure of financial relief, it was not sufficient to counteract the full financial pressures forcing service reductions, nor to provide the capital to make up for years of deferred investments in service infrastructure. As such, the limited (and now-expired) exigent surcharge is not enough to defeat the inevitable conclusion that the current rate-regulatory system has failed to serve Objective 3.[235]

The financial distress to which the current regulatory system has contributed bears on Objective 7 similarly to Objective 3. The Postal Service has striven to ensure the enhancement of mail security and terrorism deterrence within its budgets. The same can be said of other government agencies with a security mission, yet it is well-known that budget constraints can be counterproductive to any will to enhance security and deter terrorism. The price cap's threat to financial stability brings with it the risk that

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[234] Order No. 1926 at 158 ("The proposed increase is expected to maintain high quality service pursuant to 3622(b)([3]) by providing the Postal Service with the revenue required to continue its obligations under section 3691.").

[235] The focus of this proceeding is strictly on rate regulation. 39 U.S.C. § 3622(d)(3) (limiting the scope of review to "the system for regulating rates and classes for market-dominant products established under this section" (emphasis added)). However, it bears mention that other aspects of the regulatory system, such as the advisory opinion process and the annual compliance process, have been effective in increasing transparency and prompting remediation of service quality issues.

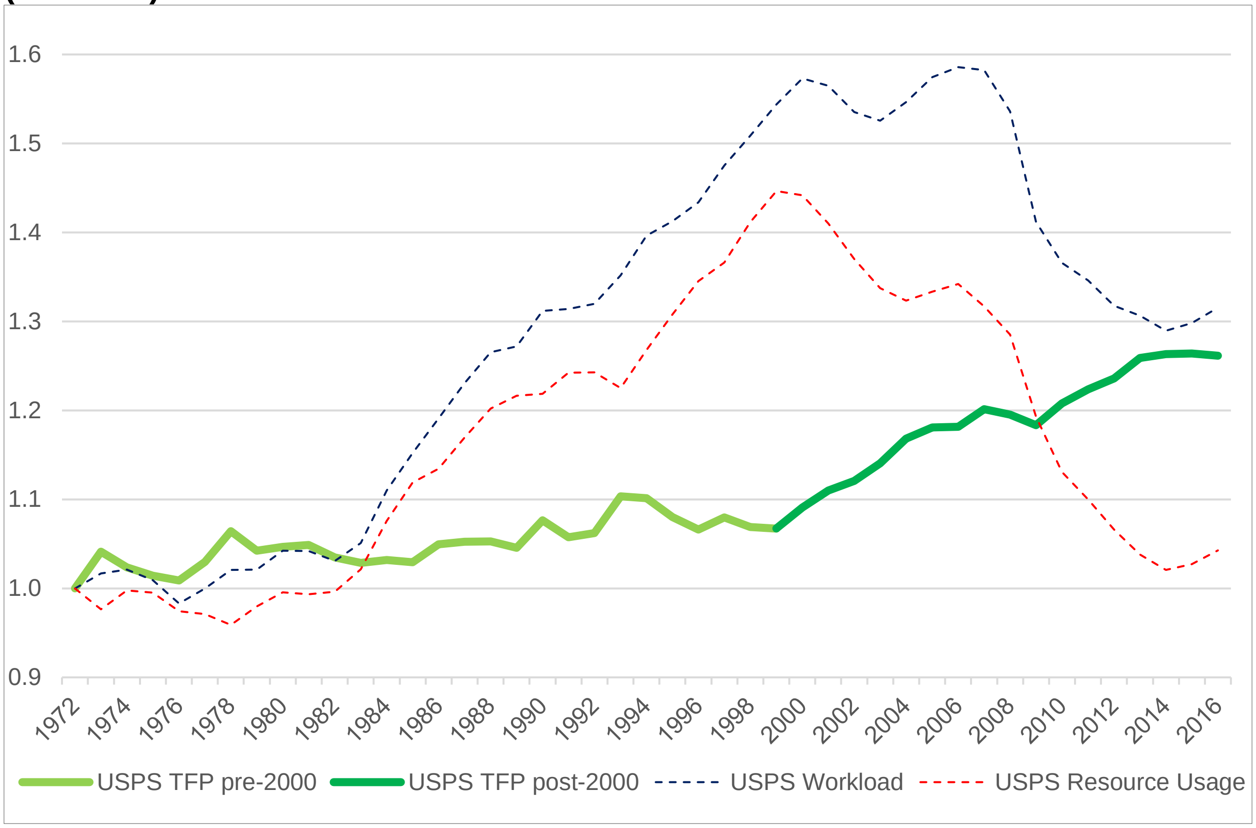
the Postal Service could in the future lack the capital to invest in security improvements. Thus, the same concern regarding Objective 3 affects Objective 7 as well: if the current system does not ensure a reliable supply of capital to invest in security enhancements, then it cannot be adequate to fulfill Objective 7. The current system does not provide adequate revenues, and so it fails to fulfill Objective 7.

C. Extrinsic Pressures Provided Strong Incentive for the Postal Service to Reduce Costs and Improve Operating Efficiency, Rendering the Price Cap Redundant and Punitive in This Regard (Objective 1; Factor 12).

As discussed in section IV.A.5.b above, the Postal Service has achieved major efficiency gains and cost reductions since the PAEA. Moreover, Congress implemented a price cap in part to ensure that the Postal Service focused on reducing costs and increasing efficiency. However, a close look at TFP data indicates that the Postal Service's 21st-century efficiency gains have less to do with the price cap than with the challenges of declining volume.

A Postal Service TFP surge began years before the PAEA. For the Postal Service's first three decades (from FY1972 until FY1999), TFP fluctuated but grew overall at a moderate pace. As the chart below highlights, around FY2000, the TFP growth trend changed sharply and began climbing steadily upward, driven by substantial declines in resource usage by the Postal Service.

Chart 11: Postal Service workload, resource usage, and TFP, 1972-2016 (1972=1.0)[236]



Of course, the FY2000 timeframe does not coincide with any change in rate regulation: the same cost-of-service model applied before and after this period. Rather, as shown in charts 7 and 9 above, it was during this period that nominal First-Class Mail volume, total contribution-weighted volume, total volume per delivery point, and total contribution-weighted volume per delivery point all peaked and began to turn downward. Consonant with those trends, workload also crested a peak in this period. It became clear that the internet would increasingly divert communications from hard-copy to electronic channels, and the Postal Service would need to become leaner in order to respond to the resulting cost pressures and loss of economies of density. For instance,

[236] United States Postal Serv., Annual Tables, FY2016 TFP (Total Factor Productivity) (Mar. 1, 2017), at Microsoft Excel file “Table Annual 2016 public (2016 CRA).xlsx,” tab Tfp-52, cells C20-E64.

in FY2002, the Postal Service experienced its second-largest workload decline ever (-1.9 percent), but still managed to achieve 1.0-percent TFP growth through a record-breaking decline in resource usage.[237]

From 2000 to 2002, the Postal Service codified its focus on efficiency in a commitment to "breakthrough productivity" and in a Transformation Plan, both of which were framed in specific response to the challenges of a changing business environment.[238] After consulting with numerous stakeholders, the Postal Service had a clear view that the unprecedented multi-year decline in First-Class Mail volumes was part of a larger, ominous trend.

> Postal Service models indicate that electronic diversion is the largest contributing factor driving the decline in First-Class Mail, single-piece letters. . . . Mail volumes were down significantly following the terrorist and anthrax attacks in the fall of 2001. While that volume decline cannot be attributed to electronic diversion, only time will tell whether the loss is temporary, or whether the events of last September and October have accelerated the rate of adoption of alternatives to the mail. Overall, it is dangerous, in the words of a large postal stakeholder group, to assume that mail volume will continue to rebound with the economy. Given the growing volatility of mail volume, there is an urgent need to build flexibility into the postal model. . . .
>
> The Internet and the World Wide Web, not even invented in 1970, have dramatically changed the communications market. Within the next decade further innovations such as mobile commerce, broadband, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. While hard copy mail retains tremendous effectiveness, there is little doubt that its share of the overall communications market will shrink. . . .
>
> The Internet is also forcing the Postal Service into greater competition with the private sector by changing the mix of mail. The Internet and electronic commerce are stimulating growth for other postal products, such as package delivery and targeted ad mail. These products

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[237] United States Postal Serv., 2002 Comprehensive Statement on Postal Operations 74 & fn.1-2 (2002).

[238] *See generally* United States Postal Serv., Transformation Plan (2002); United States Postal Serv., Five-Year Strategic Plan, FY 2001-2005 (2000), at 34-35.

> are subject to competition from traditional sources (e.g., newspaper and TV ads and other package delivery firms).[239]

In order "to keep up with rapid and significant changes in its business environment," the Postal Service set forth a commitment to significantly improve productivity through dramatic cuts in work-hours and "the most sweeping organizational changes in ten years."[240] The fruits of the Postal Service's Transformation Plan are now plain to see. Throughout this period, while workload rose in FY2004-FY2007 to match its former peak, the Postal Service reduced resource usage (or, in FY2005-FY2006, allowed it to increase more slowly than workload) and grew TFP until FY2008. As the following chart shows, the Postal Service achieved these workload reductions in large part by reducing headcount and work-hours.

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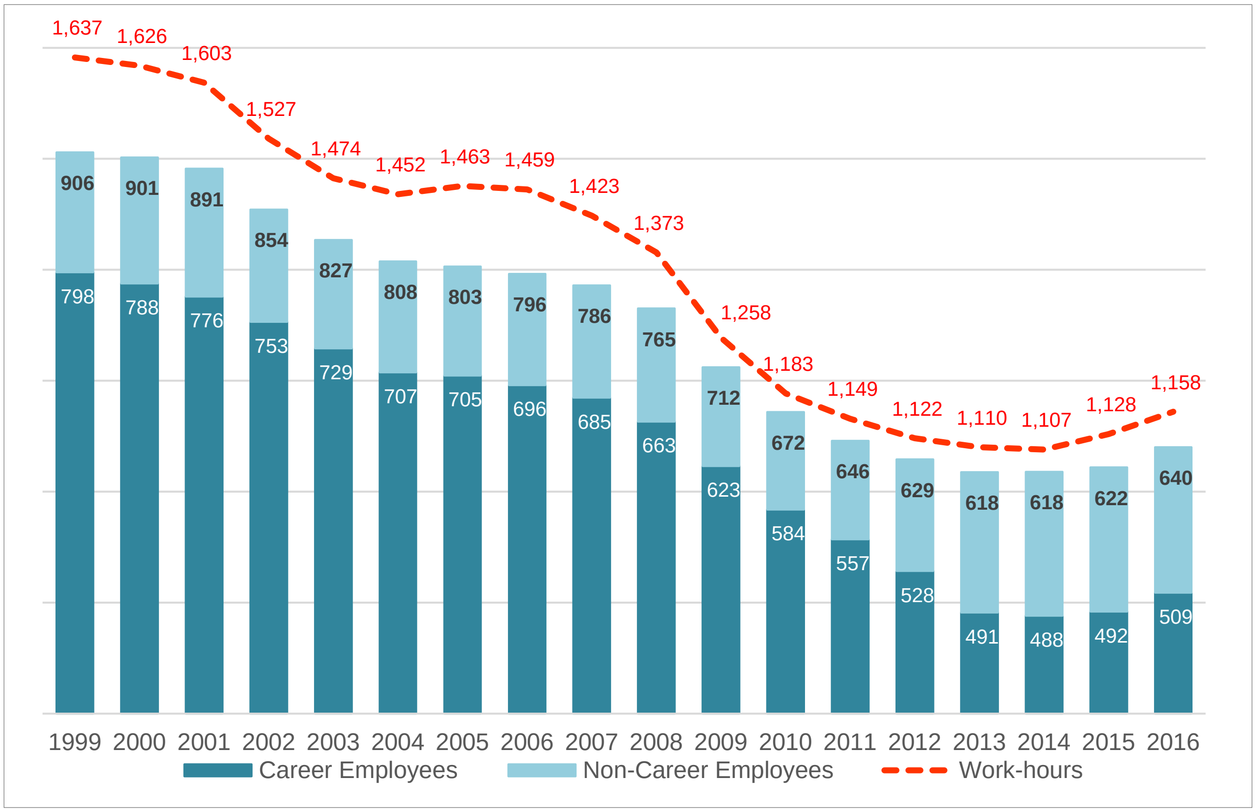
[239] *Id.* at 3-4, 6-7 (footnotes omitted).

[240] *Id.* at 11.

Chart 13: Total and career headcount and work-hours since FY1999, in thousands[241]



In FY2008 and FY2009, the entire economy stumbled, and productivity stumbled along with it. The Postal Service was no exception: for the first time since the 1990s, Postal Service TFP dropped for two years in a row, as workload (driven by mail volumes) toppled faster than the Postal Service could shrink resource usage. The Postal Service's efforts to cut costs in response to the accelerating volume declines bore fruit in FY2010, when TFP surged back and returned to its pre-FY2008 upward trend line.

These Postal Service TFP trends cannot be explained by trends in economy-wide productivity. The Postal Service is far more labor-intensive than the economy as a

[241] Numerals in black represent total headcount (career and non-career).

whole, and so it is difficult to assign meaning to a comparison between the two.[242] Given that, it is all the more notable that such a comparison would only highlight the Postal Service's achievements. In the first three decades of the PRA, the annual growth rate of Postal Service TFP fluctuated around that of nonfarm business sector (NFBS) TFP,[243] with annual Postal Service TFP growth behind that of the NFBS by an average of 0.5 percent over the period. Between FY2000 and FY2007, however, the Postal Service matched NFBS TFP growth exactly. The Postal Service TFP growth rate lagged that of the NFBS slightly during the Great Recession, but not to a large degree: if anything, that the two growth rates remained so close is a testament to the Postal Service's sustained focus on TFP throughout the Great Recession, considering that workload declined much more rapidly for the Postal Service compared to the private sector.[244] Since the Great Recession, Postal Service TFP has actually grown faster than NFBS TFP.

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[242] *See* Appendix D at 8 ("Traditionally, Postal Service TFP has been benchmarked against private nonfarm business TFP, but in recent years this comparison has become less useful because the U.S. economy has become more heavily weighted with high technology goods and services. Productivity growth in the high-tech sector far outstrips that of the industrial and service sectors that are more akin to the Postal Service. One must keep in mind this difference when comparing Postal Service TFP growth with private nonfarm business sector TFP growth.").

[243] The Bureau of Labor Statistics (BLS) uses the term "multifactor productivity" in relation to the nonfarm business sector. That term is synonymous with TFP, however, and so TFP will be used here for consistency. In addition, BLS publishes multifactor productivity statistics on a calendar-year basis, not a quarterly basis that would permit adjustment to postal fiscal years.

[244] The Postal Service's approximation of NFBS TFP since 2000 is especially dramatic in light of the fact that the NFBS's productivity gains corresponded to rising workload during all but the Great Recession years, whereas the Postal Service had to contend with the challenges of shrinking workload (due to volume declines) in all years except 2004-2007. *Id.* at 8-10. Not only did the Postal Service have to cut resource usage faster than the decline in workload, it had to do so amid statutory and political constraints that do not bind the private sector. *See* USPS Renewed Exigent Request at 23-24.

Table 2: Average annual TFP growth for the Postal Service and nonfarm business sector across various periods[245]

	Postal Service	Nonfarm business sector	Difference (USPS – NFBS)
1971-2000	0.3%	0.8%	-0.5%
2000-2007	1.4%	1.4%	0.0%
2007-2015	0.6%	0.4%	0.2%

In sum, the Postal Service's TFP growth has generally matched or slightly exceeded that of the NFBS since FY2000.

Whether the focus is on Postal Service TFP trends in isolation or in comparison with TFP among the more capital-intensive NFBS, it is clear the Postal Service's sustained productivity growth has nothing to do with the change from cost-of-service to incentive regulation, and everything to do with the pressure that secular volume declines have posed to its business model. TFP's inflection point occurred around FY2000, when key volume metrics peaked. Meanwhile, no similar inflection point coincided with the introduction of the PAEA's inflation-based price cap in FY2007 or its entry into force in FY2008. While TFP did rise during most of the post-PAEA decade, the increases fit the same trend line as pre-PAEA TFP growth, which could not have been motivated by the price cap. Indeed, the same critical driver of postal efficiency – volume declines due to electronic substitution, accelerated by economic downturns – existed and motivated TFP growth before and after the PAEA. In this regard,

[245] Appendix D at 8. The periods shown on this chart do not overlap, because the chart shows the average change in TFP between multiple pairs of years within a period. For example, the first row shows the average rate of TFP change for pairs of years until 1999-2000, while the second row begins with the change from 2000 to 2001.

accelerated resource usage, employee complement, and workhour declines following the PAEA were a consequence of the accelerated decline in volumes.[246]

The price cap has had one clear effect on operational efficiency: as discussed in section IV.A.1.a above, it has deprived the Postal Service of the ability to raise capital to invest in much needed infrastructure upgrades. As noted above in section III, the Commission has long recognized the danger that operating deficits pose to the Postal Service's efficiency progress.[247] More recently, the Commission has recognized how the Postal Service's efforts to grow TFP have been handicapped by its need to defer and reduce billions of dollars capital investments in order to subsist within the price cap.[248]

As discussed in section V.B.2 below and Appendix F, other postal regulators have agreed that market pressures provide adequate incentive for a postal operator to become as efficient as possible. There is no need for an artificial incentive, such as a rigid price cap; imposing such a cap is unnecessary to provide strong efficiency incentives and only serves to gratuitously push financial stability further out of reach. As such, to the extent that the PAEA's initial price cap system was intended as a motivator of operational efficiency, per Objective 1 and Factor 12, it has been unnecessary to that aim, and its effect has instead been strictly punitive.[249]

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[246] *Id.* at 10 ("TFP growth has been significant since the implementation of PAEA, but has not been as large as TFP growth in the years prior to PAEA, suggesting that volume trends, rather than PAEA, have been the dominant factors in determining the rate of Postal Service TFP growth.").

[247] Op. & Rec. Dec., PRC Docket No. R94-1, at ¶ 2090.

[248] FY2015 Financial Analysis Report at 19, 28.

[249] The Commission's *dictum* in the first exigent case that "the price cap is incenting the Postal Service to reduce costs and improve efficiency" does not substantially undermine this conclusion, as the entire rest of that section of the relevant order repeatedly characterizes the Postal Service's cost-cutting efforts as a response to <u>volume declines</u>, rather than to the price cap. Order No. 547 at 80-86.

D. Despite Some Improvement Over the Previous System, the Current System Has Constrained Pricing Flexibility and Pricing Efficiency (Objectives 1 and 4; Factors 2, 7, 12, 13, and 14).

In some ways, the price cap regime represents an improvement in the Postal Service's flexibility compared with the previous breakeven regime. Nonetheless, the class-level price cap inhibits the Postal Service's ability to make rational and efficient pricing decisions and to ensure that each class or type of mail covers its attributable costs. In this regard, it fails to fulfill Objectives 1 and 4, particularly when taking into account Factors 2, 7, and 14 (incorporating the policy in 39 U.S.C. § 101(d)).[250] In addition, the Commission's application of the price cap has further tightened the screws and forced the Postal Service to choose between retaining its limited price-adjustment authority and making efficiency- and value-enhancing changes to mail preparation requirements. In this regard, too, the current system fails to fulfill Objectives 1 and 4, in view of Factors 5, 7, 12, and 13.

1. The price cap both prevents and disincentivizes the Postal Service from pricing products to cover their attributable costs in a more equitable and efficient manner.

As is well-known to the Commission, the post-PAEA era has featured two leading examples of products that have been persistently unable to come close to covering their attributable costs: the Periodicals class and the Marketing Mail Flats product. Both instances are consequences of the PAEA's rigid, class-based price cap, albeit in different ways.

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[250] Section 101(d) requires postal rates "to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." *See* United States Postal Serv. v. Postal Regulatory Comm'n, 676 F.3d 1105, 1107-1108 (D.C. Cir. 2012) (upholding the Commission's interpretation of Factor 14 as incorporating 39 U.S.C. § 101(d)).

The Periodicals class entered the PAEA underwater. Indeed, it increasingly failed to cover its costs for the entire decade leading up to the PAEA.[251] The cost-coverage problem has persisted despite the fact that Periodicals' unit attributable costs have risen more slowly than those of other flats products, and have actually sunk in inflation-adjusted terms since 2004.[252] The cost-coverage problem is the result of a complex of factors, such as the fact that Periodicals entered the price cap underwater, declining volumes and density, and changes in mailer behavior that have lowered unit revenue (e.g., reducing the weight and advertising content of mailings).[253] Inasmuch as the Postal Service has tried to constrain Periodicals costs below the rate of CPI growth, unit revenue has continued to fall even faster; CPI-based price increases cannot keep pace. As a result of all of these factors, cost coverage has generally eroded since the PAEA.[254]

The price cap has failed to give the Postal Service the pricing tools to compensate for these changes. Set as it is at the class level, the PAEA's initial price cap might theoretically allow disparate price increases to address cost-coverage issues within a class, but it does not allow for the correction of an entire underwater class like Periodicals. This Commission and the Postal Service have jointly recognized the price cap's failure to address this problem:

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[251] Postal Regulatory Comm'n & U.S. Postal Serv., Periodicals Mail Study 13-15 (2011).

[252] *Id.* at 8-9. More recent CRAs bear out this trend.

[253] *Id.* at 13-15, 21-30. Since the Periodicals Mail Study, unit revenue has grown somewhat as a result of the exigent surcharge and changes in the price structure, but not enough to close the historical gap with unit cost. As discussed further in section VI.G below, to the extent that Periodicals mail is workshared, adoption of a full ECP approach to worksharing would only make matters worse, as 100 percent of worksharing-based cost reductions would translate into diminished unit revenue.

[254] FY2015 ACD at 43.

> With the rate increase limitations in the PAEA, it becomes even more difficult to overcome the revenue shortfalls for Periodicals. Greater price increases than permitted under the inflation-based price cap are likely needed to cover costs. . . . Regardless of approach [to cost savings], there will still be a cost coverage gap; without price changes or legislative changes, Periodicals will not be able to cover its costs. . . . Cost savings opportunities exist, but are not likely to be sufficient to bring Periodicals to breakeven. . . . Given the remaining financial gap, even after potential cost savings from operational efficiency improvements are realized, the focus must shift to how the revenue side of the cost coverage equation can be improved. Under the legislated mandate that applies the Consumer Price Index (CPI)-based price cap at the class level, it is extremely challenging to improve Periodicals cost coverage through pricing meaningfully, especially when the price cap has been as low as it has over the past two years.[255]

In short, the price cap system has failed to give the Postal Service the flexibility necessary to ensure that Periodicals covers its attributable costs, and hence adheres to Factor 2.[256]

In the Periodicals Mail Study, the Commission went on to agree with the Postal Service that legislative or regulatory action "which relaxes strict inflation-based price caps by class and allows for flexible pricing reflecting market dynamics might enable the Postal Service to further remedy the Periodicals cost coverage issue."[257] A legislative solution has not come, and it cannot be counted on to come.[258] The only way to remedy this failure is for the Commission to do what is within its power in this

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[255] Postal Regulatory Comm'n & U.S. Postal Serv., Periodicals Mail Study at 20, 91-92.

[256] While certain statutory factors might support some degree of preferential treatment for Periodicals, *see* 39 U.S.C. § 3622(c)(8), (11), those factors do not supersede the objectives or the "requirement" that each mail class cover its attributable costs.

[257] *Id.* at 92.

[258] The currently pending H.R. 756 would provide no additional authority to address Periodicals costs or revenues, leaving the matter to be resolved via the 10-year review, as under current law. H.R. 756's revisions to Section 3622's objectives and factors would not appear to have a material effect on this particular issue. *See* H.R. 756, 115th Cong. § 203(a) (2017). At most, H.R. 756 would speed resolution by requiring the Commission to conclude the proceeding by a date certain. *Id.* § 208.

proceeding: to acknowledge the long-established fact that the price cap has failed in these regards and must be reformed to achieve the objectives, in light of the relevant factors.

The price cap's effect on Marketing Mail Flats is less direct, but no less palpable. As with Periodicals, Marketing Mail Flats' cost coverage has declined since the PAEA.[259] Unlike Periodicals, Marketing Mail Flats is only one product within a larger mail class. In theory, the Postal Service could remedy the cost-coverage problem by devoting a disproportionate amount of Marketing Mail's overall price increase authority to that goal. The Postal Service has done this to some extent – in fact, to a greater extent than the Commission has required[260] – but a far more radical allocation of limited pricing authority would be necessary to achieve full cost coverage. Why, then, has the Postal Service not done so already?

The problem is that Marketing Mail Flats' volume is in autonomous decline relative to that of other Marketing Mail products. This renders "the net impact on Postal Service contribution from raising prices on underwater products . . . ambiguous, at best."[261] If the Postal Service were to maximize price increases for Marketing Mail

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[259] FY2015 ACD at 51.

[260] Reply Comments of the United States Postal Service, PRC Docket No. ACR2016 (Feb. 13, 2017), at 10-11. A similar situation concerns Media Mail and Library Mail, two linked products within the Package Services class, which have failed to cover their attributable costs every year of the past decade. *See* United States Postal Service FY 2016 Annual Compliance Report, PRC Docket No. ACR2016 (Dec. 29, 2016), at 54-55; FY2015 ACD at 67. The Commission has tended to acknowledge this circumstance while noting the Postal Service's ongoing plans to target those products for above-average price increases and the products' educational, cultural, scientific, and informational value (Factor 11). *E.g.*, FY2015 ACD at 67-68.

[261] Reply Comments of the United States Postal Service, PRC Docket No. ACR2014 (Feb. 17, 2015), at 20 (citing CHRISTENSEN ASSOC., SCENARIO ANALYSIS FOR STANDARD MAIL CONTRIBUTION 2, *filed as* Library Reference USPS-FY12-43, PRC Docket No. ACR2012 (Dec. 28, 2012), at 2). *See also* Appendix E at 11.

Flats, any victory in terms of positive unit contribution might be short-lived if the product's overall contribution dwindles as volumes continue to fall (and probably at an increasing rate, as a result of the price increases). Meanwhile, the Postal Service would have forgone the opportunity to increase contribution from Marketing Mail products with stable or rising volumes.[262] Particularly in a time with limited CPI and, consequently, limited class-level price increase authority, it would be imprudent for postal management to pursue such a strategy. Thus, if Marketing Mail Flats fail to cover their costs (per Factor 2 and Factor 14, incorporating the policy in 39 U.S.C. § 101(d)), and if Marketing Mail rate relationships fail to be efficient (per Objective 1), it is because the current system has failed to provide the pricing flexibility (Objective 4 and Factor 7) and incentives necessary to address the problem.[263]

2. As applied by the Commission, the current price cap system creates a catch-22 between discouraging efficiency- and value-enhancing measures or moving farther from revenue adequacy.

As if the price cap did not already constrain the Postal Service's flexibility and efficiency enough in other regards, a decade of experience has uncovered new strictures. In particular, the Commission has interpreted the price cap requirement such that the Postal Service's already-limited pricing authority can be further diminished

[262] For a fuller discussion of this issue, and of why contrary arguments that other parties have presented are not valid, see Appendix E at 11; Reply Comments of the United States Postal Service, PRC Docket No. ACR2014 at 20-23; Reply Comments of the United States Postal Service, PRC Docket No. ACR2013 (Feb. 14, 2014), at 2-5; USPS Exigent Reply Comments at 113-14; Reply Comments of the United States Postal Service, PRC Docket No. ACR2012 (Feb. 15, 2013), at 6-14; CHRISTENSEN ASSOC., SCENARIO ANALYSIS FOR STANDARD MAIL CONTRIBUTION; United States Postal Service Response to Order No. 1541, PRC Docket No. R2013-1 (Nov. 26, 2012), at 5-6; Library Reference USPS-R2013-1/7, Standard Mail Contribution Model, PRC Docket No. R2013-1 (Oct. 11, 2012).

[263] "It is important to remember that [this problem only arises] in the presence of a price cap." CHRISTENSEN ASSOC., SCENARIO ANALYSIS FOR STANDARD MAIL CONTRIBUTION at 1 fn.2.

when (1) it deletes or redefines a rate cell or (2) "changes to a basic characteristic of a mailing" are "significant" enough to be deemed the "functional equivalent" of rate cell deletion or redefinition.[264] The effect is to force the Postal Service to choose between either increasing prices or implementing changes that significantly encourage efficient mail preparation and the adoption of intelligent mail (Factors 5, 7, 12, and 13); it cannot do both. On a basic level, this approach drives the current system farther away from the objectives of efficiency, predictability, stability, and flexibility (Objections 1, 2, and 4), not closer to them. By discouraging the Postal Service from incentivizing customers to adopt value- and efficiency-enhancing product features, it also subverts the PAEA framers' intent to "develop an organizational culture of innovation and market responsiveness" and to "increas[e] the attractiveness of mail to both new and existing customers."[265]

The point here is emphatically <u>not</u> to relitigate the merits of the Commission's decision. To be sure, the Postal Service disagrees with that decision and is advocating for it to be overturned on judicial review. Nevertheless, for the sake of argument here, the Postal Service will leave aside its dispute and accept the Commission's premise that treatment of "significant" mail preparation requirement changes as effective price changes is necessary and critical to avoiding evasion of the current system's price cap requirement.[266] Although the Commission's interpretation is not actually mandated by

[264] *See generally* Order No. 3441; Order No. 3047, Order Resolving Issues on Remand, PRC Docket No. R2013-10R (Jan. 22, 2016).

[265] S. REP. NO. 108-318, at 16.

[266] Order No. 3441 at 17-20.

the PAEA,[267] it is a gloss on the price cap, an integral part of the current system. As such, evaluation of the price cap's success or failure in fulfilling the statutory criteria must account for the Commission's interpretation as part of the current system.

In that vein, it is important to note that the current system has forced the Postal Service to forgo eliminating an Intelligent Mail discount category, the effect of which would have been to promote the use of Full-Service Intelligent Mail. This use of the Postal Service's pricing flexibility, in turn, would have simplified the rate schedule and incentivized mailers to switch to Full-Service Intelligent Mail at an even faster clip, with benefits for the mailers in the form of deeper discounts and more valuable mailpiece data, for the Postal Service in terms of efficiency and mail volume, and for all stakeholders in the form of fuller service performance measurement. In one fell swoop, the Postal Service would have furthered Objectives 1, 3, and 4 and Factors 1, 5, 6, 7, 11, and 12. Yet the price cap, as applied by the Commission, would impose a heavy cost for doing so: the sacrifice of precious pricing authority, which would drive the Postal Service even farther from the objectives of adequate revenues and compensatory rates (Objectives 5 and 8). Faced with this conundrum, the Postal Service chose to favor preserving revenues, at the expense of furthering the other objectives and factors.

To the extent that the Commission maintains that its interpretation is part and parcel of the current system, then it is only fair to acknowledge and evaluate the manner

[267] *See* U.S. Postal Serv. v. Postal Regulatory Comm'n, 785 F.3d 740, 751 (D.C. Cir. 2015) (holding that the statutory phrase "changes in rates" is ambiguous, and therefore subject to Commission interpretation).

in which it pits key objectives and factors against one another.[268] Any system that does so cannot be judged to have achieved those objectives and factors.

E. The Current System Has Achieved or Been Neutral on Some Objectives, But That Does Not Mitigate the System's Critical Failings (Objectives 2, and 6).

The current system has not failed every statutory objective; it has been neutral on, and even achieved, a few of them. The current system, with its price cap, annual price increase schedule, and advance notice of proposed rates, generally promotes predictability and stability in rates, per Objective 2. The administrative burden is generally lower for streamlined post-PAEA ratemaking proceedings than for the ten-month rate cases before the PAEA, and transparency is higher (Objective 6). However, these achievements cannot counteract the significant failure of the cap to achieve the other objectives.

Moreover, while the immediate question is whether the current system has succeeded or failed on its own merits, it bears noting that the current system is not the exclusive means of, and therefore is not essential to, fulfilling Objectives 2 and 6. For example, as discussed in section VI.C below, even a system without a price cap or with a different price cap model can be predictable and stable, and it can involve even lower administrative burden than the current system. The current system's neutral or positive results in terms of Objectives 2 and 6 cannot justify maintaining the current system in the face of its failure to meet almost all other objectives.

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[268] In denying the Postal Service's motion for reconsideration, which addressed conflict between the objectives and factors and the Commission's interpretation, the Commission noted that "the price cap [i]s a binding constraint." Order No. 3441 at 19-20. Of course, that no longer provides a basis to fail to address the issue here, where the issue is precisely whether the price cap should remain a binding constraint in light of its success or failure at achieving the objectives and accounting for the factors.

F. Continuation of the Current System Cannot Rationally Be Justified.

The current system does not have a record of achievement, and it does not provide a basis to expect achievement in the future. Nor does that future promise changes that might offer the current system a path to achievement.

1. The Postal Service would continue to face financial instability and red ink.

The fundamental problem of the current system's unsuitability to the Postal Service's business pressures, and its concomitant failure to achieve Objectives 1, 3, 5, 7, 8, and 9, has no chance of abating. Prior volume declines have placed the Postal Service in a highly precarious financial condition. Moving forward, the most reasonable expectation is that First-Class Mail volume will continue its decline, due to electronic diversion. Marketing Mail volume will, at best, stabilize or, more likely, decline more slowly than First-Class Mail volume. Those two sets of expectations yield a mail mix that will continue to shift toward lower-contribution products. Meanwhile, institutional costs will continue to rise as population and economic growth create ever more addresses to serve. Postal management will maintain its sharp focus on achieving all available cost-savings opportunities, and additional cost-savings opportunities have been identified. However, they are not enough to close the gap. In other words, average cost will continue to rise, and there will be fewer pieces of mail to cover those rising costs. If prices remain frozen at inflation, the resulting real revenue from market-dominant products will continue to shrink, leaving the Postal Service with ever-declining liquidity and moving it ever farther from the objectives of financial stability, compensatory rates, and the means to invest in service, security, and productivity-enhancing infrastructure upgrades.

Furthermore, the Postal Service has been, and will continue to be, obligated to make substantial payments to finance the post-retirement benefits that it is statutorily required to provide. Regarding pensions, the Postal Service must make annual payments to cover normal costs in its FERS account (approximately $3.4 billion, or more, per year through FY2020), and it will soon be subject to a new requirement to amortize the unfunded liability in the CSRS (approximately $1.2 billion per year). In addition, OPM has determined that the Postal Service's FERS account is now underfunded, and that an annual amortization payment of approximately $0.2 billion is owed (although the Postal Service has appealed that determination). Regarding RHB, while the fixed payment schedule ended last year, the Postal Service must now make annual payments to cover normal costs and amortize the unfunded RHB liability, for a presumable total annual cost (approximately $5.9 billion per year on average through FY2020) that will exceed the former fixed payments.[269] Therefore, while the Postal Service will benefit from the fact that the RHB Fund will pay annuitant premiums, the total average annual normal cost and amortization payments required for pension benefits and RHB will be very large, amounting to approximately $10.0 billion, or more, per year through 2020. This is in addition to the approximately $1.4 billion that the Postal Service must pay the Department of Labor each year to cover workers'

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[269] This expectation and the charts in Appendix G assume that the $33.9 billion in missed RHB prefunding payments will be amortized, though it may be through a separate payment from the amortization of the unfunded actuarial liability. OPM has previously taken the position that the defaulted payments would be within the unfunded actuarial liability. *See Continuing to Deliver: An Examination of the Postal Service's Current Financial Crisis and its Future Viability*: *Joint Hearing Before the House Subcomm. on Fed. Workforce, Postal Serv., & the District of Columbia & the House Comm. on Oversight and Gov't Reform*, 111th Cong. 258 (2010) (question for the record response from OPM) ("The failure to make the [fixed pre-funding] payment would cause there to be a lower balance in the Postal Service Retiree Health Benefits Fund, which thus would require higher Postal amortization payments beginning in FY 2017."). However, OPM has not confirmed whether it will adopt that approach in practice. The Postal Service expects OPM to clarify the matter by June of this year.

compensation expenses. Again, while these expenditures will remain constant, or could even grow, volume is expected to continue to sink, leaving the financial gap to grow ever wider unless prices can be adjusted to yield more contribution.

The charts in Appendix G show what these expectations mean for the future of the current system. The charts posit two alternative scenarios: (1) a reasonable baseline scenario based on an econometric forecast of volumes and revenues, external consensus economic indicators (i.e., employment and investment levels, growth in e-commerce and exports, and exchange rates), and the prospect of a recession with half the impact on the Postal Service of the Great Recession;[270] and (2) an optimistic scenario based on the same initial volumes and revenues, but with no recession in the next decade. The scenarios incorporate the same reasonable – and, in some cases, even aggressive – assumptions about employment costs, cost reductions and efficiency gains, competitive product pricing, and the amount of post-retirement benefits funding obligations to be paid each year.[271] Critically, they also assume that market-dominant product price increases will continue to be limited to CPI. In both scenarios,

[270] The Postal Service modeled the impact of such a recession and smoothed it over the ten-year period of the projection. For purposes of this illustrative exercise, it is reasonable to interpolate a recession sometime in the next decade, albeit one less severe than the abnormally rocky Great Recession. Only once in the past 160 years has the U.S. economy gone more than ten years between recessions, and then only barely; in the post-World War II era, the average period between recessions is five years and 8.5 months. Nat'l Bureau of Econ. Research, U.S. Business Cycle Expansions and Contractions, http://www.nber.org/cycles/cyclesmain.html (last visited Feb. 23, 2017). Hence, it is reasonable, for purposes of this illustrative exercise, to interpolate a recession around FY2018, albeit one less severe than the abnormally rocky Great Recession. As of this filing, the period since the start of the last recession (110 months) is already the third-longest in recorded history.

[271] For example, these forecasts assume that the Postal Service will through continued aggressive management achieve a high proportion of the cost savings opportunities within management control that the A&M Report discusses, in order to capture the potential reduction in work-hours arising from reduced mail volumes. Another aggressive assumption is that the Postal Service will be able to price competitive products above inflation over the long term, notwithstanding the likelihood that market pressures might further constrain prices and yields. It should be noted that these assumptions do not necessarily represent an actual forecast or strategy; rather, they are intended to illustrate that, even with aggressive actions in other areas, a continued CPI-only price cap on market-dominant products cannot work.

continuation of a CPI-only price cap will starve the Postal Service of cash by next year and doom it to another decade of escalating losses.

Thus, no matter how realistic or rosy the scenario, the current system has nothing to offer but another decade of non-compensatory rates, financial instability, and a lack of cash to invest in service, security, and efficiency upgrades. The only way to continue delivering the mail for even a short time would be to default on a number of statutorily-mandated post-retirement benefits payment obligations: an outcome inconsistent with the notion of self-sufficiency and the statutory objectives of financial stability and just and reasonable rates. As such, it would continue to fail to achieve Objectives 1, 3, 5, 7, 8, and 9.

2. Wishful thinking cannot make up for the current system's failure.

Some commenters might like to tempt the Commission with visions of futures where the current system could work, if only some other saving grace were to appear. Some such hypotheses are beyond the Commission's legal capacity to entertain, such as those relating to labor negotiations and the possibility of postal reform legislation. In particular, while the Postal Service is urging Congress to enact such legislation, the Commission must conduct this review based on the statute in effect at this time. In any event, pending postal reform legislation would not obviate the need to replace the current system. Nor should the Commission accept pleas to second-guess management decisions or engage in gimmickry that seeks to obfuscate the severity of the Postal Service's current financial condition. Such arguments from commenters cannot furnish a sound basis to overlook the current system's proven failings.

a. The Commission cannot fail to act in the hope of legislative relief that might never come or that might be insufficient.

Some might urge the Commission to refrain from reforming the price cap at this time, because, in their view, imminent legislative reform could solve the Postal Service's financial problems and make the current system workable. The Postal Service would join with those voices in urging Congress promptly to enact reforms that relieve it of certain unnecessary financial burdens. And the Postal Service would agree that, if and when such legislation might actually be enacted, it could affect the size of the financial hole to be filled through market-dominant rate increases enabled through regulatory reform (and continuing, aggressive management action). However, the Postal Service has been clear that legislation of the sort currently pending before Congress would not affect the need for regulatory reform. As discussed in section III.B.3.d above, the Commission has previously recognized that it cannot predicate the conduct of its proceedings on the prospect of legislative reform; therefore, it cannot delay the conduct of this review in the hope of legislative relief. While the Postal Service certainly shares the hope that this will be the Congress to enact meaningful postal reform, the legislative process is simply not reliable enough to excuse a conclusion that the system might work after all or deferral of this important review.

Even if it were relevant to this proceeding, not even the current House bill would provide enough financial relief to allow the current rate-regulation system to achieve the objectives into the future. As the Postmaster General has testified, "Congressional action on legislative reform would minimize the size of the price increases needed to cover our costs," but it would not avoid them altogether.[272] The estimated savings from H.R. 756 would not be enough to restore the Postal Service's financial stability under either the baseline scenario or the optimistic scenario discussed in section IV.F.1 above. While H.R. 756 would bend the financial curves, enacting that legislation alone would not bestow long-term financial stability on the Postal Service. In sum, the timing and final outcome of postal reform legislation cannot be foreseen. Only two things are certain. First, the Commission itself has rightly articulated its role as applying the law as is, rather than on the basis of – or in an effort to bring about – hypothetical legislative changes. Second, even if H.R. 756 were relevant and enacted promptly and without change, it is not designed to place Objectives 1, 3, 5, 7, 8, and 9 within reach of the current system, and it therefore does not avert the need for regulatory reform.

b. The Commission may not deny relief in the hope of influencing labor arbitrators.

The Postal Service expects that other commenters will argue that the current system could be adequate but for postal employees' wage premium.[273] Whether or not that debatable premise is correct, it is beside the point in this proceeding. As noted in section III.B.3.e.ii, the Commission is not legally able to rule on the wage premium or any other subject of collective bargaining. Pay comparability is addressed through the

[272] Brennan Testimony at 12 (emphasis added).

[273] *See* Motion of MPA—The Association of Magazine Media and Alliance of Nonprofit Mailers for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 6, 2017), at 7; *see also* Corrected Reply of MPA—The Association of Magazine Media, Alliance of Nonprofit Mailers, and Association for Postal Commerce to Opposition of the United States Postal Service to January 17 Motion for Issuance of Information Requests, PRC Docket No. RM2017-3 (Jan. 27, 2017), at 12-13. The Commission refused to accept the joint movants' reply into the record for decision in this proceeding. Order No. 3763, Order on Motions for Issuance of Information Requests, PRC Docket No. RM2017-3 (Jan. 30, 2017), at 2 fn.4. Still, it is referenced here strictly as an illustration of the arguments that these and other parties might make in their record comments.

collective bargaining process, and binding interest arbitration is the sole channel to resolve any impasse. None of this is to say that a more flexible rate-regulation system implies laxity about labor costs. As described in section IV.A.5.a above, the Postal Service has aggressively pursued new cost-reduction flexibilities through labor negotiations, arbitration, and non-bargaining-unit policy changes.[274] It will continue to do so. These changes have helped, but the Postal Service's financial reports clearly show that they have not allowed the Postal Service to meet its statutory obligations. Future cost-savings opportunities that require labor consensus would almost certainly come with mitigating concessions. There is no legal or practical basis, however, for the Commission to second-guess what can realistically be accomplished, much less to sustain a patently unsustainable system on that basis.

c. The available potential for further cost reductions and efficiency gains is not large enough to avert the need for pricing reform.

A popular canard holds that the Postal Service could do just fine under the current system if only it were more efficient. The devil, however, is in the details. As the Office of the Inspector General (OIG) aptly summarized, "legal hurdles to adjusting the size, configuration, compensation, and deployment of the workforce, and stakeholder opposition to changes in the processing, delivery, and retail networks" "have blunted any efficiency-promoting qualities of the price cap. . . . The result was intensive pressure to economize, but limited ability to do so."[275]

To test these competing hypotheses, the Postal Service engaged A&M, with the support of the Institute for Supply Management, to conduct a comprehensive review of

[274] *See* USPS Renewed Exigent Request at 27-31; USPS Exigent Reply Comments at 91-93, 97-100.

[275] OIG Price Cap Report at IV.

its operations and to identify and quantify significant outstanding opportunities for efficiency savings. The study covered all aspects of postal operations and included review of hundreds of documents and voluminous data; in-depth process reviews, discussions, and field observations at 16 postal network facilities; and interviews with over 60 Postal Service executives, managers, and subject-matter experts. The resulting report is included in Appendix C.

After examining the opportunities that remain available following the cost reductions and efficiency gains that have already occurred, A&M concluded that the savings opportunities still available to postal management are far from adequate to fill the projected ten-year operating deficit, let alone provide adequate financial stability.

> Even if USPS successfully implements all the recommendations, under the current constraints and pricing structure, there is no path forward for USPS to close its net cash shortfall by the end of FY26, let alone achieve financial stability of reduced debt levels and increased levels of operating cash on hand. Operational improvements alone are not sufficient to allow USPS to close its net cash shortfall position within the next 10 years. . . . [I]t is the Team's assessment that a change to the current CPI-U price cap and/or significant regulatory/legislative changes will be required to close USPS's net cash shortfall over the next 10 years.[276]

Although A&M was able to identify total cost-savings opportunities adding up to $2.6 billion per year on average, almost two-thirds of that figure requires labor, regulatory, and/or political consensus and therefore is ultimately outside of management's control, leaving only approximately $1.0 billion in average annual cost savings within management's control.[277] Even full achievement of all identified savings opportunities –

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[276] Appendix C at 5 (emphasis in original).

[277] *Id.* at 4. This quantification includes only opportunities that A&M identified as meeting a $100 million threshold. Other opportunities were identified but not quantified, either because they did not meet this threshold or because they could not be accurately quantified due to data and time constraints. *Id.* at 5 fn.9.

including those that depend on outside actors' consensus – would only close 22 percent of the expected 10-year net cash shortfall, leaving a $55-billion gap.[278] (While management technically has the ability to negotiate with labor organizations as to many cost-savings opportunities, the concessions that would be needed to secure labor consent could substantially reduce A&M's projected savings figures.)[279] Therefore, the A&M Report disproves the aforementioned canard: the Postal Service cannot simply cut its way to "living within the price cap."

Equally important is the fact that A&M uncovered no wholly new cost-savings opportunities that postal management had heretofore overlooked. The $1.0 billion in average annual cost savings within management control reflects the continuation or modification of cost-savings initiatives already in process. This shows that postal management is already comprehensive in reviewing opportunities for efficiency gains. The A&M Report underscores the point that there is no magic bullet for the Postal Service's financial woes lying unnoticed in the bottom of its efficiency toolkit.

d. The Commission may not assume service cuts or other theoretical management strategies in order to justify maintaining the current system.

Some might argue that the current system could meet all of the objectives if only postal management followed this or that business strategy. In essence, the argument would be that the Commission should sustain the artificial pressure of the current system as a way of forcing the Postal Service to make business decisions in line with the commenter's preference. Some of the ideas that parties might propose are not in

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[278] *Id.* at 5.

[279] *See id.* at 5 fn.8.

keeping with best practices, however; others are not amenable to change in any event; and still others would give the Commission too heavy a hand in managing postal business operations.

The Postal Service will continue to evaluate its network to identify opportunities to balance cost-reduction efforts with the American people's service expectations. However, that balance must be maintained; service cannot simply be sacrificed blindly in the interest of financial stability. At some point, that would only prove the point in section IV.A.4 above that, by failing to provide adequate revenues to maintain financial stability, the current system would threaten the Postal Service's ability to maintain high-quality service standards, consistent with Objective 3. Moreover, given political and practical constraints, as well as the universal service obligation, the soundness and impact of any theoretical service reductions cannot simply be postulated in the abstract within the context of this review of the rate-regulation system. The Commission has rightly rejected past efforts to use theoretical service changes, without regard to their feasibility or appropriateness, as an excuse to uphold the rigidity of the current system.[280]

Finally, here, too, there simply is not much "there" there. As discussed in the previous two sections and in section IV.A.5.a above, the Postal Service has already availed itself of most of the appropriate opportunities for service-related cost reductions

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[280] *See* Order No. 1926 at 131, 134-35 ("Unlike a private enterprise, the Postal Service must consider the impact of its cost-cutting activities on its ability to continue to provide postal services consistent with the policies of title 39, United States Code. . . . That further opportunities for cost reductions in this area exist is not sufficient to persuade the Commission that reducing costs in this area would eliminate the need for an exigent rate increase. Although converting from door delivery might reduce costs, Valpak has not shown that converting from door delivery would also allow the Postal Service to maintain and continue to develop postal services of the kind and quality adapted to the needs of the United States.").

at this time.[281] The Postal Service is in the process of evaluating whether further consolidation of its processing network is in order under current service standards. The Postal Service has also reduced the cost of its retail network through the Post Office Structure Plan (POStPlan), which the Commission "commend[ed]."[282] The Postal Service has also pursued mode of delivery issues regarding centralized and curbside delivery at an appropriate pace, in light of political and revenue concerns. A&M has confirmed that management is already availing itself of the cost-reduction opportunities within its control. Beyond these measures, anything further would require political and stakeholder consensus, as well as a clear understanding of any service changes' impact on the value of the mail, and hence on volumes and revenues. For example, Congress has shown no interest in allowing the Postal Service to reduce delivery frequency. Moreover, issues regarding mode of delivery are currently being considered by Congress. Whatever arguable margin for efficiency improvements might remain beyond the measures identified in the A&M Report, it is far from enough to cover billions of dollars in legislative mandates essentially on its own, with little help from an anemic CPI price cap.

[281] *E.g.*, Appendix C at 10-12; USPS Renewed Exigent Request at 22-27; USPS Exigent Reply Comments at 93-94, 100-105.

[282] Postal Regulatory Comm'n, Advisory Opinion on Post Office Structure Plan, PRC Docket No. N2012-2 (Aug. 23, 2012), at 1. Notably, the Commission did not have such a favorable opinion of an earlier initiative to identify postal retail locations for potential closure, which the Postal Service abandoned in favor of POStPlan within months of the Commission's advisory opinion. *See id.* (describing POStPlan as a "significant improvement over the previous Retail Access Optimization Initiative"); Postal Regulatory Comm'n, Advisory Opinion on Retail Access Optimization Initiative, PRC Docket No. N2011-1 (Dec. 23, 2011), at 1 ("The primary Commission finding is that notwithstanding its name, the Retail Access Optimization Initiative is not designed to optimize the retail network.").

Another possible argument is that the Postal Service's financial problems exist only on paper, and they would go away if only management changed how it prepared its balance sheet. Several variations of this argument are possible: RHB liabilities are ephemeral, since the Postal Service has not been penalized for missing past payments; pension liabilities should be presented as if calculated on the basis of the postal workforce's demographics and salary growth; real and personal property assets should be accounted for at market value, rather than at historical cost.[283] None of these arguments are availing, and none presents a basis to ignore the current system as the root of the problem.

The Commission should reject calls to engage in accounting sleight-of-hand to pretend that the Postal Service's financial outlook is better than it is. The generally accepted accounting principles (GAAP) that underlie the Postal Service's financial statements – and, by extension, its forecasts – are generally accepted because they reflect a commonly-understood set of expectations and are designed not to be misleading.[284] Many private companies, including those in the mailing industry, likewise must follow GAAP when preparing their financial reports. A departure from GAAP is only justified in exceptionally "unusual circumstances" where GAAP compliance would

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[283] *See* Motion of MPA—The Association of Magazine Media and Alliance of Nonprofit Mailers for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 6, 2017), at 6-7; *see also* Corrected Reply of MPA—The Association of Magazine Media, Alliance of Nonprofit Mailers, and Association for Postal Commerce to Opposition of the United States Postal Service to January 17 Motion for Issuance of Information Requests, PRC Docket No. RM2017-3 (Jan. 27, 2017), at 9-12. The Postal Service acknowledges again that this reply is not part of the record for decision; it serves here solely to illustrate possible arguments.

[284] *See* 39 U.S.C. § 3654(c) (requiring independent auditor opinion); CODE OF PROFESSIONAL CONDUCT, Rules 1.320.001, .010, .030 (Am. Inst. of Certified Public Accountants 2016) (requiring auditors, as a condition of their qualification, to certify GAAP conformity and only permit departures in "unusual circumstances" to avoid misleading statements).

itself be misleading, and a departure is unlikely to be justified if it has an "unusual degree of materiality" and is at odds with "industry practices."[285] If a commenter is proposing a departure from accepted financial principles as a means to convert a patently dire outlook to a decidedly rosier one, such as by ignoring multibillion-dollar RHB and other benefits funding obligations, then it can only be because such a departure has an "unusual degree of materiality" and would be an inappropriate basis for decision.[286]

With specific regard to the assumptions used to calculate postal pension liabilities, proponents of this particular argument might point to a pending OPM rulemaking on the subject.[287] However, hypothetical regulatory changes are no more relevant to the Commission's task than hypothetical legislative changes.[288] Moreover, OPM's proposed rule would only require the use of postal-specific demographic assumptions, with the use of postal-specific economic assumptions left entirely to the discretion of OPM's Board of Actuaries.[289]

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[285] CODE OF PROFESSIONAL CONDUCT, Rules 1.320.001.01, .030.03. For example, industry practice does not support a departure from GAAP's requirement to value a firm's property, plant, and equipment at historical cost, rather than current market value. Opposition of the United States Postal Service to Motion for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 10, 2017), at 15 fn.34.

[286] *Cf.* Sec. & Exch. Comm'n, Non-GAAP Financial Measures: Questions and Answers of General Applicability, Question 100.01 (last updated May 17, 2016), https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm (warning that non-GAAP share performance measures can be misleading if, for example, they exclude "normal, recurring, cash operating expenses necessary to operate a [firm's] business").

[287] Federal Employees' Retirement System; Government Costs, 81 Fed. Reg. 93,851 (2016).

[288] *See* section IV.F.2.a *supra.* As with any potential legislative changes, the impact of this regulatory change could be assessed at the time. In any event, the financial benefits of such a change are immaterial to assessing whether the current system is achieving the objectives.

[289] 81 Fed. Reg. at 93,853; *see* Opposition of the United States Postal Service to Motion for Reconsideration of Order No. 3763, PRC Docket No. RM2017-3 (Feb. 10, 2017), at 3 fn.24; Response of the United States Postal Service in Opposition to MPA—The Association of Magazine Media and Alliance of Nonprofit Mailers' Motion for Issuance of Information Requests, PRC Docket No. RM2017-3 (Jan. 24, 2017), at 3 fn.5.

Nor is there any basis to inflate the reported value of the Postal Service's property assets according to some notion of current market value. The market value of a firm's property portfolio is not typically relevant to investors, regulators, or other stakeholders while the firm remains a going concern. It might be relevant when a firm is being wound down and must use its assets to satisfy creditors, or possibly when it is being acquired by another firm keen to understand what it is paying for. Neither of those situations applies here, where the issue is simply whether the Postal Service may raise its prices above inflation in order to ensure financial stability and meet other objectives. In addition, there is no comprehensive or suitably representative information on which to base such an adjustment.[290]

At this point, no alternative business strategy available to the Postal Service – alone or in combination – would have a big enough impact to avert the need for reform of the rate-regulation system. As the economists' joke goes, if a piece of paper lying on the sidewalk looks like a twenty-dollar bill, then it can't possibly be one, or else someone would have picked it up already. By the same token, if any magic solution existed that both were in the Postal Service's power and could actually sustain it within the strictures of the current system, the Postal Service would have adopted it already. Of course, efficient market theory to the contrary, there are a number of valid reasons

[290] While the OIG has occasionally made superficial forays into this topic, it has explicitly cautioned that its estimates are speculative, based on tiny and admittedly non-representative samples, and not sufficiently rigorous to be reliable. U.S. Postal Serv. Office of the Inspector Gen., FF-MA-11-118, Leveraging Assets to Address Financial Obligations 2-3, 9-10 (2011). One OIG estimate consists of nothing more than an adjustment to book value based on CPI and an assumed rate of return for commercial investment properties. U.S. Postal Serv. Office of the Inspector Gen., FT-MA-12-002, Pension and Retiree Health Care Funding Levels 6 & fn.20 (2012).

why passers-by might not already have picked up a $20 bill on the sidewalk,[291] and similar arguments could be made with respect to postal business decisions. Be that as it may, postal management must be allowed some margin of business judgment; the Commission's role is not to impose its own business judgment by arbitrarily maintaining ineffective rate regulations as a stick with which to influence the Postal Service's, Congress's, or OPM's decision-making on unrelated issues.

V. FOREIGN POSTAL REGULATORS' EXPERIENCE UNDER SIMILAR LEGAL STANDARDS SHOWS THAT RIGID OR INFLEXIBLE PRICE CAPS ARE UNSUITED TO THE MODERN POSTAL ECONOMY

The undertaking before the Commission is hardly unique. Other postal regulators in industrialized countries have been grappling with the same problem of how to sustain universal postal services in a time of volume declines and financial threat, while ensuring the continuation of progress on efficiency and other aims that protect consumers.

Beyond the substantive lessons that foreign postal regulators' experience might hold, a look at foreign postal regulators' rulings in similar proceedings testifies to the utility of international comparisons in the first place. In the United Kingdom (U.K.), the postal regulator (the Office of Communications or Ofcom) found that "international precedent" justified a primarily after-the-fact approach in the U.K., as before-the-fact price regulation "has not stopped many international operators having to increase prices, or facing reduced profits" (including, in particular, in the United States).[292] More

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[291] For variants on the joke scenario that illustrate these criticisms, see "The $20 bill on the sidewalk," Financing Efficiency Blog, Oct. 19, 2011, https://financingefficiency.wordpress.com/2011/10/19/the-20-bill-on-the-sidewalk.

[292] Ofcom, Securing the Universal Postal Service: Decision on the New Regulatory Framework (Mar. 27, 2012) [hereinafter "Ofcom March 2012 Decision"], at 59,

recently, Ofcom drew on other postal regulators' use of an EBIT metric for financial stability and benchmarked Royal Mail's financial performance against that of certain other countries' postal operators.[293] Moreover, the German regulator Bundesnetzagentur (BNetzA) recently began testing its allowed price increases for Deutsche Post against those in 29 other European countries.[294] Like Ofcom, BNetzA also benchmarked Deutsche Post's financial performance against that of other postal operators, concluding that there was no statistical basis to limit the comparison on the basis of differences in national demographics, postal market structure, universal service parameters, regulatory model, or postal operators' business structure.[295] These examples show that international comparisons can be, and are, used effectively to shed light on solutions to common problems in postal regulation, particularly how to ensure the financial sustainability of universal postal service in an era of universally declining volumes.

International comparisons illuminate all of the Commission's inquiries in Order No. 3673. Not only are postal regulators grappling with the same factual problems,

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https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.

[293] Ofcom, Review of the Regulation of Royal Mail: Consultation Document (May 25, 2016), Annex 6 at 46-47, 54-58, https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf.

[294] Bundesnetzagentur [BNetzA] [Federal Network Regulatory Agency], Beschluss wegen Zusammenfassung von Dienstleistungen und Vorgabe von Maßgrößen für die Price-Cap-Regulierung für Briefsendungen von 1000 Gramm ab 01.01.2016 [Decision Concerning the Grouping of Services and Prescription of a Price Cap Regulatory Framework for Letters up to 1,000 Grams Effective January 1, 2016], Docket No. BK5-15/012 (Nov. 23, 2015), at 61-65, http://tiny.cc/BK5-15-012 [hereinafter "BNetzA, BK5-15/012 Decision"].

[295] *Id.* at 30-45. Specifically, BNetzA found that differences in regulatory model were irrelevant to profitability, as all postal operators faced the same problems from volume declines; moreover, upon an empirical review, BNetzA found that there was no statistical correlation between postal operator profitability and date of market opening, number of delivery days, population density, urbanization, mail volumes, per-capita gross domestic product, per-capita income, ownership structure, or publicly traded status. *Id.* at 31-41, 86-88.

many of them are seeking to achieve regulatory objectives that parallel those at issue in this proceeding. Pursuant to those similar objectives, postal regulators in most industrialized countries have recognized that permanent, and often significant, above-inflation price increases are necessary to ensure the future of universal service and will not jeopardize other regulatory objectives. A close look at four such regulatory systems reveals a trend away from rigid price-cap regulation, either by abandoning before-the-fact price cap regulation in recognition of inherent constraints on the postal operator's pricing discretion, or by simultaneously narrowing and loosening price cap mechanisms. Because the latter group of countries' mechanisms remain complex and continue to inhere greater risk of regulatory error, the Postal Service submits that the former approach – shifting to after-the-fact regulation – would be more appropriate for the Commission to adopt, as discussed in section VI.

A. Similar Foreign Postal Price-Regulation Standards Provide a Basis for Interpretive Guidance and Comparison.

Many industrialized countries' postal regulators operate under pricing standards similar to those that govern this proceeding. For example, similar to the PAEA's objectives of "just and reasonable" rates, efficiency incentives, and "adequate revenues," Canadian postage rates must be "fair and reasonable," must support "the efficient operation of the business of [Canada Post] Corporation" (Canada Post), and must "so far as possible provid[e] a revenue, together with any revenue from other sources, sufficient to defray the costs incurred by [Canada Post] in the conduct of its operations."[296] Like the balance implied in the PAEA's "just and reasonable" objective,

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[296] Canada Post Corporation Act, R.S.C., ch. C-10, § 19(1)-(2) (1985), *available at* http://www.canlii.org/en/ca/laws/stat/rsc-1985-c-c-10.

regulatory approval of Canada Post's price increases has been premised on an analysis of the costs and benefits for the postal operator and relatively vulnerable consumers. For instance, a 2014 price increase was justified by need to cover the rising costs of universal service and ensure "the financial viability of Canada Post"; at the same time, it was noted that the price increases would impose only small annual cost burdens on the average household (CAD 5.25) and small business (CAD 60.00).[297] In addition, Canada Post was commended for a number of cost-reduction measures that it had undertaken to mitigate its losses.[298]

Similarly, in the European Union (EU), all postal regulators must ensure that prices are both cost-oriented and affordable, and prices must "give incentives for an efficient universal service provision."[299] National laws that transpose the EU's postal directive[300] make the comparison with the PAEA's objectives even more apparent. For example, the United Kingdom's (UK's) Postal Services Act 2011 requires the regulator Ofcom to "have regard to the need for the provision of a universal postal service to be financially sustainable [including a reasonable rate of return], and the need for the provision of a universal postal service to be efficient."[301] In terms of monitoring

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[297] Regulations Amending the Letter Mail Regulations, SOR/2014-48, 148 C. Gaz. 751, 753-54, 759 (Mar. 26, 2014), http://gazette.gc.ca/rp-pr/p2/2014/2014-03-26/pdf/g2-14807.pdf.

[298] *Id.* at 757.

[299] Council Directive 97/67, art. 12, *as amended by* Council Directive 2008/6, art. 1(14), 2008 O.J. (L 52) 3, 15, *available at* http://eur-lex.europa.eu/eli/dir/2008/6/oj.

[300] EU "directives" establish minimum standards or objectives that each EU member state must implement through national legislation, in contrast to directly applicable EU "regulations." *See* KLAUS-DIETER BORCHARDT, THE ABC OF EUROPEAN UNION LAW 88-91(2010), *available at* http://bookshop.europa.eu/en/the-abc-of-european-union-law-pbOA8107147.

[301] Postal Services Act 2011, c. 5, § 29(3)-(4), *available at* ohttp://www.legislation.gov.uk/ukpga/2011/5/pdfs/ukpga_20110005_en.pdf.

"affordability," Ofcom, like the Canadian authority, focuses on the impact of price increases on those consumers "most likely to be at risk of not being able to afford universal postal services," such as small and medium-sized businesses and low-income, elderly, and disabled individuals and those without internet access.[302] Ofcom also established an "indicative" profit margin range for the postal operator Royal Mail; outside of this range, financial inadequacy or excessive profits could justify renewed regulatory intervention, as could insufficient efficiency progress or excessive impacts on vulnerable consumers by Royal Mail.[303]

In France, postal legislation requires postal services to be "offered at affordable prices to all users," to be "cost-oriented," and to "encourage efficient delivery, while taking into account the characteristics of the applicable markets."[304] The French postal regulator ARCEP has drawn from these EU-based legislative mandates the following governing principles, some of which resemble the PAEA's objectives of "adequate revenues," efficiency incentives, "just and reasonable," pricing flexibility, and predictability:

- The price-regulation framework should allow the postal operator to maintain its financial margin, provided that it realizes its potential for efficiency gains in the context of the current postal market, and it should ensure that these benefits are shared with mailers;

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[302] *See generally* Ofcom, The Affordability of Universal Postal Services (Mar. 19, 2013), https://www.ofcom.org.uk/__data/assets/pdf_file/0014/10445/affordability.pdf. For more on the different methods that European postal regulators use to test affordability, see EUROPEAN REGULATORS GROUP FOR POSTAL SERVICES, ERGP (14) 22, ERGP REPORT ON TARIFF REGULATION IN A CONTEXT OF DECLINING VOLUMES 29-31 (2014), http://tiny.cc/ERGP-2014-tariff-reg [hereinafter "ERGP, TARIFF REGULATION"].

[303] *See* Ofcom March 2012 Decision at 5-6, 46-51, 81.

[304] CODE DES POSTES ET DES COMMUNICATIONS ÉLECTRONIQUES [Postal and Electronic Communications Code] art. L1, para. 4 ("*Ces services* [*postaux*] *sont offerts à des prix abordables pour tous les utilisateurs. Les prix sont orientés sur les coûts et incitent à une prestation efficace, tout en tenant compte des caractéristiques des marchés sur lesquels ils s'appliquent.*"), available at https://www.legifrance.gouv.fr/affichCode.do?cidTexte=LEGITEXT000006070987.

- It must provide the operator with multi-year predictability, such as will allow it to develop its prices within the regulatory framework;

- It must incentivize the operator to achieve efficiency gains, allowing the operator to fully recoup the value of any efficiency gains beyond the level strictly necessary to comply with framework's constraints;

- It must also account for the investments and profound changes in productivity that the operator has made since 2003;

- It must account for the new context of the mail market, characterized by a stagnation of addressed letter volumes and faced with uncertainty about the future volume trends; and

- It must address the risk that these developments pose to the operator's economic outlook, by distributing those risks equitably between the operator and mailers.[305]

Finally, in Germany, regulated postage rates must reflect the "costs of efficient service provision," a phrase that captures both objectives of cost-orientation and efficiency.[306] Specifically, the German price cap formula incorporates, among other

[305] L'Autorité de Régulation des Communications Électroniques et des Postes [ARCEP] [Electronic Communications and Postal Regulatory Agency], Décision n° 06-0576 sur les caractéristiques d'encadrement pluriannuel des tarifs des prestations du service universel postal [Decision No. 06-0576, Characteristics of the Multiannual Tariff Framework for Universal Postal Delivery Services] (June 1, 2006), at 2, http://www.arcep.fr/uploads/tx_gsavis/06-0576.pdf ("*[L]'encadrement tarifaire doit permettre le maintien de la marge de l'opérateur, sous la condition qu'il réalise les gains d'efficacité possibles dans le contexte actuel des marches postaux, et garantir qu'une partie de ces gains bénéficie aux utilisateurs; il doit donner à l'opérateur une visibilité pluriannuelle; cette visibilité lui permettra de faire évoluer la structure de sa tarification conformément aux principes tarifaires du service universel postal; il doit être incitatif pour l'opérateur, en permettant que les gains d'efficacité qu'il réalise au delà du niveau strictement nécessaire au respect de la contrainte d'encadrement lui reviennent intégralement; il doit tenir compte également de l'effort d'investissement et des profondes mutations del'outil industriel de production que l'opérateur a engagés depuis 2003; il doit tenir compte du nouveau contexte des marchés du courrier, caractérisé par une stagnation des volumes d'envois adressés, et confronté à des incertitudes sur l'évolution future des volumes; il doit appréhender le risque que représente cette évolution sur l'équation économique de l'opérateur, en le répartissant équitablement entre l'opérateur et les usagers.*").

[306] POSTGESETZ [POSTG] [Postal Act] § 20(1) ("*Genehmigungsbedürftige Entgelte haben sich an den Kosten einer effizienten Leistungsbereitstellung zu orientieren*[.]"), *available at* http://www.gesetze-im-internet.de/postg_1998. For a translation, see German Law Archive, Postal Act (Postgesetz, PostG), http://germanlawarchive.iuscomp.org/?p=718 (Mar. 28, 2014). For a further English-language description, see BNetzA, The Price Cap Regime from 2012: Benchmark Procedure – Key Elements (July 15, 2011), at 8, http://tiny.cc/BNetzA-Key-Elements (Ger.) [hereinafter "Key Elements Paper"].

things, a mechanism to periodically rebalance prices with the costs of efficient service provision.[307] The costs of efficient service provision include not only long-run incremental costs that the regulator deems to have been efficiently incurred, but also certain legally mandated common costs that are beyond the postal operator's ability to control and a reasonable rate of return benchmarked against the profit margins of other European postal operators.[308] As a result, this mechanism effectively aims at sustaining the postal operator while guarding against excessive profits, similar to the PAEA's "adequate revenues" and "just and reasonable" objectives.

These foreign legal authorities show that the same concerns animate both the PAEA's objectives and foreign postal regulatory regimes and offer some guidelines for the Commission's interpretive framework. In some regards, Order No. 3673 is clearly on the same track as the Commission's foreign peers:

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[307] POST-ENTGELTREGULIERUNGSVERORDNUNG [PENTGV] [Postal Rate Regulation Ordinance] § 4(3) ("*Bei der Vorgabe von Maßgrößen, insbesondere bei der Festlegung der Produktivitätsfortschrittsrate, ist das Verhältnis des Ausgangsentgeltniveaus zu den Kosten der effizienten Leistungsbereitstellung (§ 3 Abs. 2) zu berücksichtigen.*"), available at http://www.gesetze-im-internet.de/pentgv/BJNR238600999.html; see also BNetzA, Key Elements Paper at 11 ("Section 4(3) of the Ordinance states that the ratio of the initial price [i.e., the average price in effect before the new price control period] . . . to the efficiently incurred costs of providing service must be taken into consideration when setting benchmarks, most notably when determining the expected productivity growth rate. If the initial price exceeds the efficiently incurred costs of providing service, a correspondingly higher x-factor is required to approximate prices to the cost of efficient service provision level.").

[308] PENTGV § 3(2) ("*Die Kosten der effizienten Leistungsbereitstellung ergeben sich aus den langfristigen zusätzlichen Kosten der Leistungsbereitstellung und einem angemessenen Zuschlag für leistungsmengenneutrale Gemeinkosten, jeweils einschließlich eines angemessenen Gewinnzuschlags, soweit diese Kosten jeweils für die Leistungsbereitstellung notwendig sind.*"); see also BNetzA, Key Elements Paper at 8 ("Pursuant to section 3(2) of the Ordinance the efficiently incurred costs of providing service are derived from the long run incremental costs of providing service and an appropriate mark-up for volume-neutral common costs, each inclusive of a profit mark-up corresponding to the entrepreneurial risk, in so far as these costs are required for providing service. . . . If the regulated operator demonstrates costs which exceed the efficiently incurred cost of providing services, these are regarded as costs which are not necessary for the efficient provision of services. These costs are only taken into consideration to the extent that, and for as long as, good legal or objective reasons exist under section 20(2) of the Postal Act and section 3(4) of the Postal Rates Regulation Ordinance. Appropriate account must be taken in particular of the costs of providing postal services nationwide and of the cost of staff pensions for those employees inherited as a result of the legal succession to Deutsche Bundespost.").

- **"Maximize incentives to reduce costs":** The Commission recognizes that this objective must account for statutory constraints and focus on operating and controllable costs.[309] Similarly, all of the foreign laws discussed above demand efficiency. Canadian and U.K. oversight authorities monitor and account for the respective postal operators' efficiency progress. German postal law adjusts prices for efficiently incurred costs and only those "inefficient" costs that result from external mandates. The French regulator enumerates various criteria for examining past, current, and expected efficiency when approving rates.
- **"Adequate revenues" and "just and reasonable":** The Commission recognizes that revenues must be sufficient to cover the Postal Service's short-, medium-, and long-term costs and to afford financial integrity, while preventing "misuse of the Postal Service's monopoly power" (such as through excessive profits).[310] By the same token, all of the foreign laws discussed above strike a balance between allowing prices to cover costs (as well as, in France, Germany, and the U.K., a reasonable rate of return) and sustain universal service into the future, while also avoiding excessive profits and/or remaining "affordable" for vulnerable consumers.

In other regards, foreign postal regulatory experience suggests additional concepts to incorporate into the Commission's framework. The Commission has acknowledged that foreign postal regulatory systems can serve as a reference point to

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[309] Order No. 3673 at 4.

[310] *Id.* at 7, 9-10.

measure pricing flexibility.[311] As Appendices E and F show, foreign postal regulatory models show that "pricing flexibility" involves judgments about whether prices are regulated *ex ante* or *ex post*; the amount of deference given to the postal operator's business judgment; the scope of products subject to *ex ante* price regulation or other regulatory safeguards; whether any *ex ante* price controls apply on an average basis across all regulated products or more discretely to specific sub-groupings; and the amenability of any price control to adjustment or reopening ahead of schedule. The Commission should include these concepts in its metrics for pricing flexibility.

B. Foreign Postal Regulatory Models Show That Only a More Flexible, Reality-Based System Can Achieve the Objectives in the Current Market Environment.

1. Over the last decade, postal prices have almost universally risen faster than inflation throughout Europe, Canada, and Australia.

The last decade has visited the same dilemma upon every major industrialized country's postal system: a secular decline in letter volumes, accelerated by the global Great Recession and coupled with incessant growth in fixed network costs, leading to excess capacity, declining economies of density, and rising average unit costs. The result is an existential threat to the future of universal postal service.[312]

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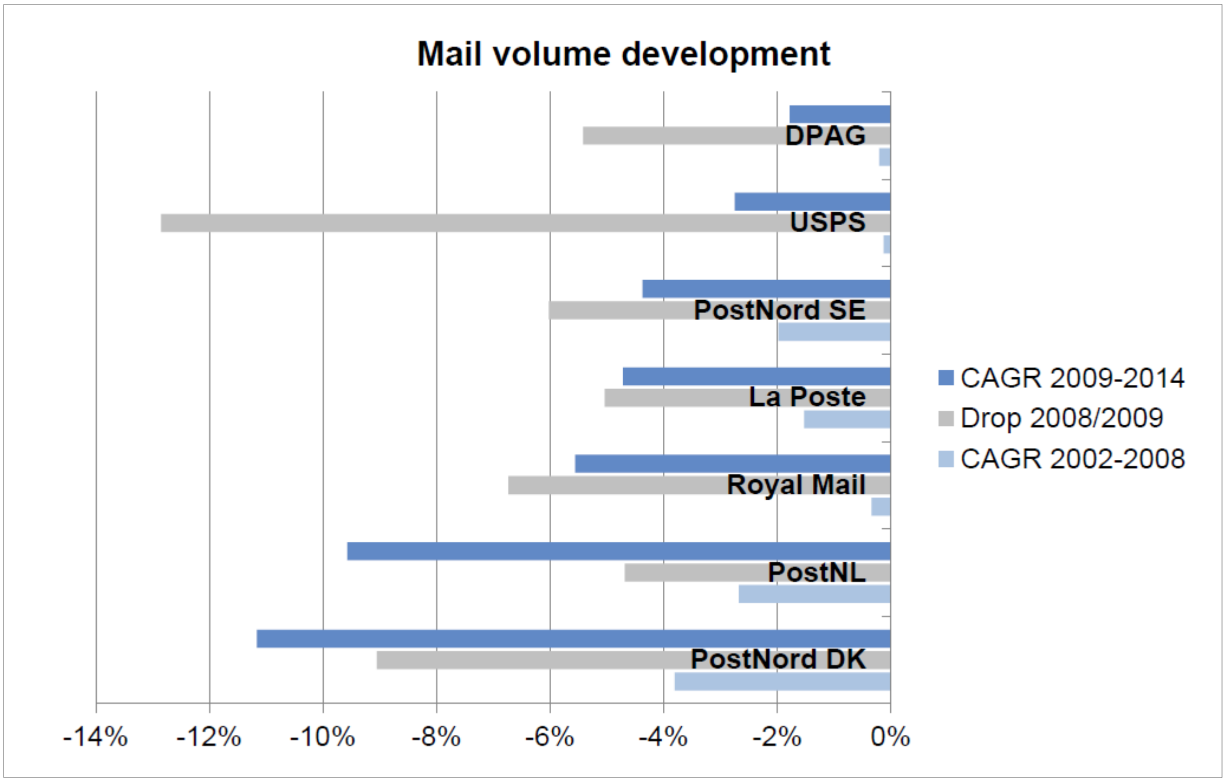
[311] *Id.* at 6-7.

[312] E.g., BNetzA, BK5-15/012 Decision at 61 ("*So sehen sich die Briefmärkte im europäischen und außereuropäischen Ausland . . . einem stetigen und zum Teil erheblichen Rückgang des Mengenaufkommens und damit einhergehenden Marktschrumpfungsprozessen ausgesetzt. Durch die Mengenrückgänge warden die etablierten Briefdienstleister mit spezifischen Herausforderungen konfrontiert, wie z. B. der Kostendeckung für die Vorhaltung von Infrastruktureinrichtungen des Universaldienstes, Kapazitätsauslastungsrisiken, Produktivitätsverschlechterungen und Stückkostensteigerungen aufgrund von Kostenremanenzeffekten.*"); ERGP, TARIFF REGULATION at 3 ("The economic model of postal operators is characterized by the presence of economies of scale (the more volumes are delivered, the lower the unit cost). Operators may have both a significant proportion of labor costs and obligations of public service. These factors may limit the ability of postal operators to adapt to the decline of volumes whilst also taking into account their USO obligation."); see also EUROPEAN REGULATORS GROUP FOR POSTAL SERVICES, ERGP (15) 27, REPORT ON CORE INDICATORS FOR MONITORING THE EUROPEAN POSTAL MARKET 29-32 (2015), http://tiny.cc/ERGP-2015-indicators (showing that, across

Chart 14: International comparison of changes in mail volume[313]



Faced with such a threat, many postal regulators have realized that it is no longer possible to expect prices both to remain capped at consumer inflation (or less than consumer inflation) and to provide for a sustainable postal system.

> [T]he relevance of price caps seems to be declining. The reason for this is that volume declines already put significant pressure on postal operators to cut cost and reduce the risk of unreasonable high profits. Moreover, the declining share of postal service consumption in household budgets makes the affordability concern [reflected in the EU postal directive and implied by the PAEA's "just and reasonable" objective] less relevant. For example, an individual sending five letters per year will most likely not find

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21 European countries between 2011 and 2014, non-express volumes declined by an average of 6.5 percent per year and total mail volume per capita by an average of 5.7 percent per year); HENRIK B. OKHOLM, ET AL., PRICING BEHAVIOUR OF POSTAL OPERATORS 38 (Copenhagen Economics 2012), http://tiny.cc/CE-pricing-behaviour (showing that letter volumes dropped by more than 20 percent across 15 European countries between 2007 and 2012).

313 WIK-CONSULT, REVIEW OF THE PROJECTED COSTS WITHIN ROYAL MAIL'S BUSINESS PLAN 29 (2016), https://www.ofcom.org.uk/__data/assets/pdf_file/0019/72145/projected-costs-review.pdf. From top to bottom, the countries represented are Germany, the United States, Sweden, France, the U.K., the Netherlands, and Denmark.

it unaffordable if the price for delivering a letter increases from 0.5 Euro to 1.5 Euro. . . .

Whereas price caps impose a ceiling on prices, cost-orientation [as required by the EU postal directive and implied by the PAEA's "just and reasonable" objective] also imposes a floor. A problem can thus occur when the ceiling is lower than the floor[.] . . . If the price cap requires postal service to be provided at a price below cost, this may ultimately also challenge the [regulatory objective of] sustainable and efficient provision of universal services[.] . . .

The need for price caps can be investigated by means of an assessment of the four generic justifications for price control: Risk of unaffordable products, risk of excessive profits, risk of reduced efficiency incentives, and risk of cross-subsidisation. To ensure the fulfilment of regulatory objectives without compromising the ability for postal operators to cover their costs, more light-touch approaches such as monitoring of tariffs and ex-post intervention might be more appropriate. Good practice is in this context provided by the UK and Denmark, where the [national regulatory authorities] have removed price caps on priority mail (based on an assessment of their necessity) and replaced them with safeguard measures on second class mail.

If price caps are considered necessary, they should be designed with sufficient flexibility. For example, in times of rapid volume decline, it is imperative that the regulatory design recognises the need for business process re-engineering rather than assuming continuation of existing business models. This can be achieved if the price-cap model contains a volume adjuster which allows for higher prices to compensate for higher unit costs due to reduced economies of scale. If the [universal service provider] is not allowed to perform such adjustments this might imply a risk that the provision of universal services becomes financially unsustainable.[314]

Or, as the European Regulators Group for Postal Services put it:

In particular, the volume decline brings different problems to tariff regulation, among others:
- for service providers with a certain amount of fixed costs and economies of scale, this development leads to an increase of unit cost increasing tension between the principles of affordability of universal service, which would tend to favour stable or declining prices, and cost orientation, which would tend to favour price increase to match increased unit cost[.] . . .

When in place, a price cap should allow pricing flexibility for the incumbent acting in highly dynamic market environments and protect[ ] consumers against excessive prices.

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[314] Okholm, et al., Pricing Behaviour of Postal Operators at 24, 233-34, 263-64, 271-72.

> In times of significant market changes such as that in the postal sector, the design and scope of the price regulation may need some reflection. Accordingly the decrease of letter volumes should be considered when specifying the guidelines for the price regulation regime.[315]

As a specific example of this sentiment, U.K. regulator Ofcom turned down calls to use the PAEA as a model for price regulation, citing instead the Postal Service's multibillion-dollar losses as evidence that a strict price cap was not "a sustainable model" for how to finance universal postal service.[316]

Ofcom's recognition of the need for above-inflation price increases is emblematic of a Europe-wide trend. Among 31 European countries, the basic letter postage rate (that is, the first weight step for a domestic priority letter) increased by an average of 5.4 percent per year between 2008 and 2015, more than double the average annual rate of consumer inflation among the same countries over the same period (2.2 percent), as shown below.[317]

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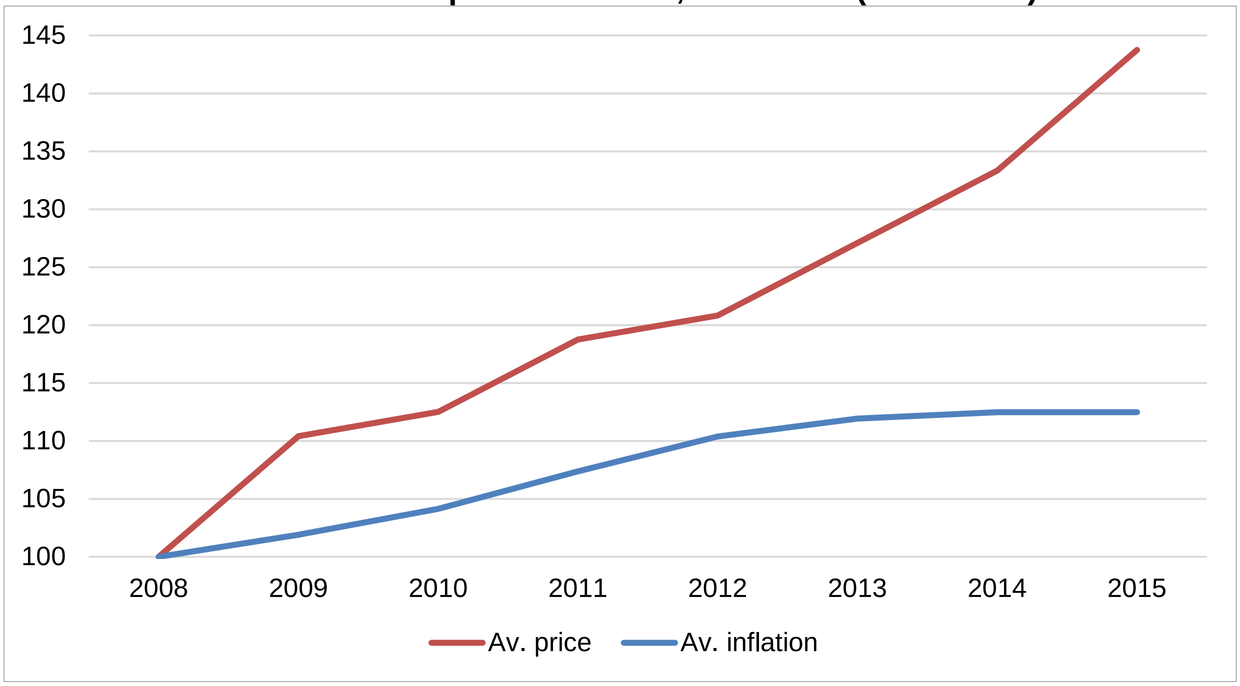
[315] ERGP, Tariff Regulation 3-4.

[316] Ofcom March 2012 Decision at 59 ("In the case of USPS which was raised by a number of respondents, price rises are low but it has recently announced losses of $3.3 billion for the last quarter. We do not consider that this is a sustainable model for the UK.").

[317] *Compare* European Regulators Group for Postal Services, ERGP (16) 46, Flash of the ERGP Report on Core Indicators for Monitoring the European Postal Market 1 (2016), http://tiny.cc/ERGP-2016-indicators, *with* Eurostat, Eurostat, HICP (2015 = 100) – Annual Data (Average Index and Rate of Change) [prc_hicp_aind]. These averages are not weighted according to relative volumes or other factors. The Former Yugoslav Republic of Macedonia is included in the average price data but not in average inflation, due to the unavailability of data for that country in Eurostat.

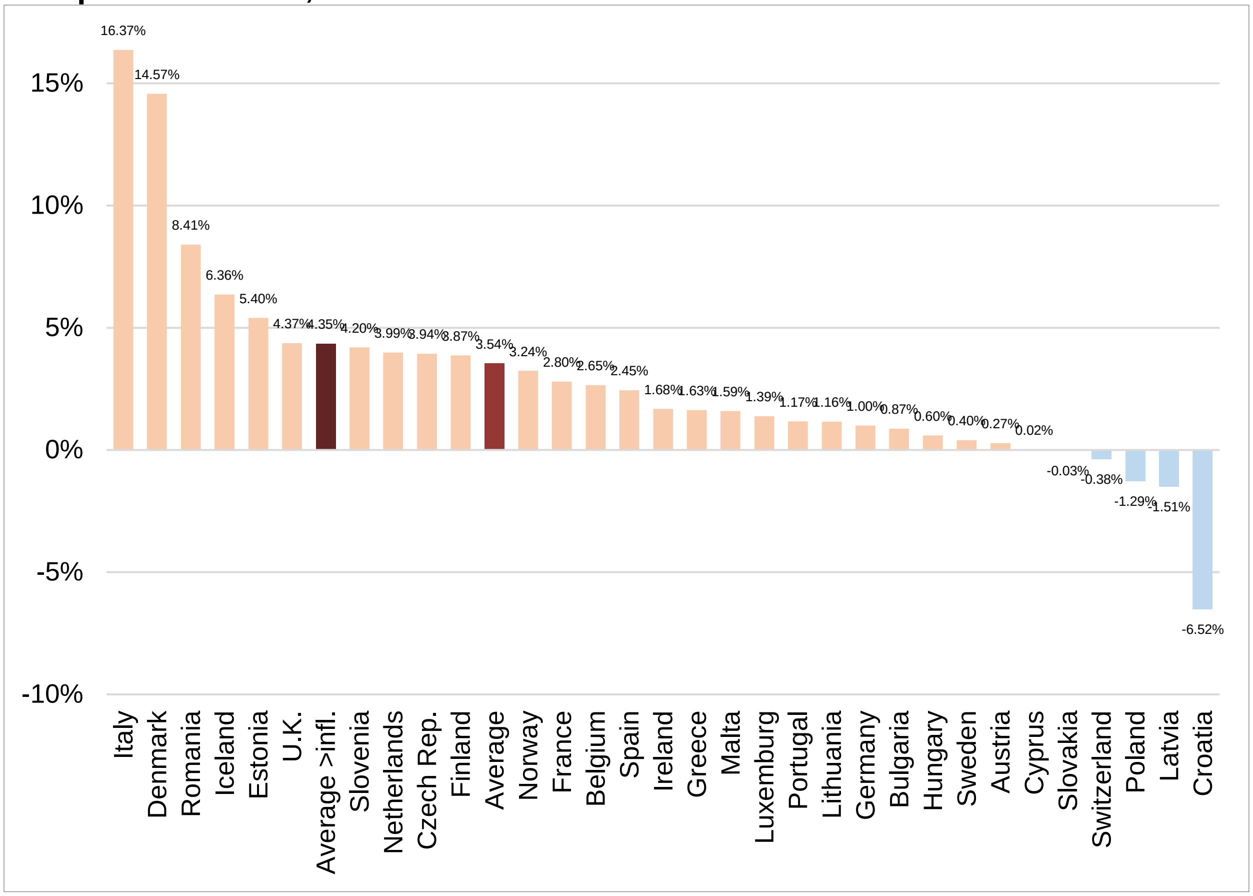
Chart 15: Comparison of (unweighted) average changes in basic letter prices and consumer inflation in 31 European countries, 2008-2015 (2008 = 100)[318]



The next chart shows that this trend is widely distributed across European countries, with only a few relatively small outliers having managed to confine price increases to or below household inflation. On average, prices across all 31 countries increased 3.54 percent above inflation per year; among only those with above-inflation price increases, the average annual increase was 4.35 percent above inflation.

[318] Data from the sources in the preceding footnote was converted to a common index with 2008 as the base year for purposes of this illustration.

Chart 16: Average annual change in inflation-adjusted basic letter prices in 31 European countries, 2006-2015[319]



Other studies bear out the point that prices have risen faster than consumer inflation across Europe.[320]

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[319] *See* DEUTSCHE POST AG, LETTER PRICES IN EUROPE 11 (2016), *available at* http://tiny.cc/DP-letter-price-2016. Deutsche Post presents each postal operator's total price increase over the ten-year period; this chart shows the compound annual growth rates derived from Deutsche Post's data. It should be noted that the countries with above-inflation increases represent the overwhelming share of total letter volumes. *See* BNetzA, BK5-15/012 Decision at 43-44 (showing, in the right-hand column of the table, the relative letter volumes of all of the countries on the chart above, except Germany and Iceland, as of 2014). Deutsche Post observes that the substantial decrease in Croatia was due to the abolition of value-added tax for letter delivery in 2010, DEUTSCHE POST AG, LETTER PRICES IN EUROPE at 10; this suggests that the decrease in prices may not have had a substantial effect on the postal operator's net revenues.

[320] BNetzA, BK5-15/012 Decision at 63-65 (calculating that the letter price increase among 22 of 29 surveyed European postal systems – representing more than 94 percent of the total group's letter volumes – was 2.9 percent above inflation per year between 2009 and 2014; on a volume-weighted basis, the total annual average increase across all 29 countries was 2.92 percent above inflation); OKHOLM ET AL., PRICING BEHAVIOUR OF POSTAL OPERATORS at 32-35, 39-65 (finding that most letter prices rose faster than inflation across 26 European countries between 2004 and 2011).

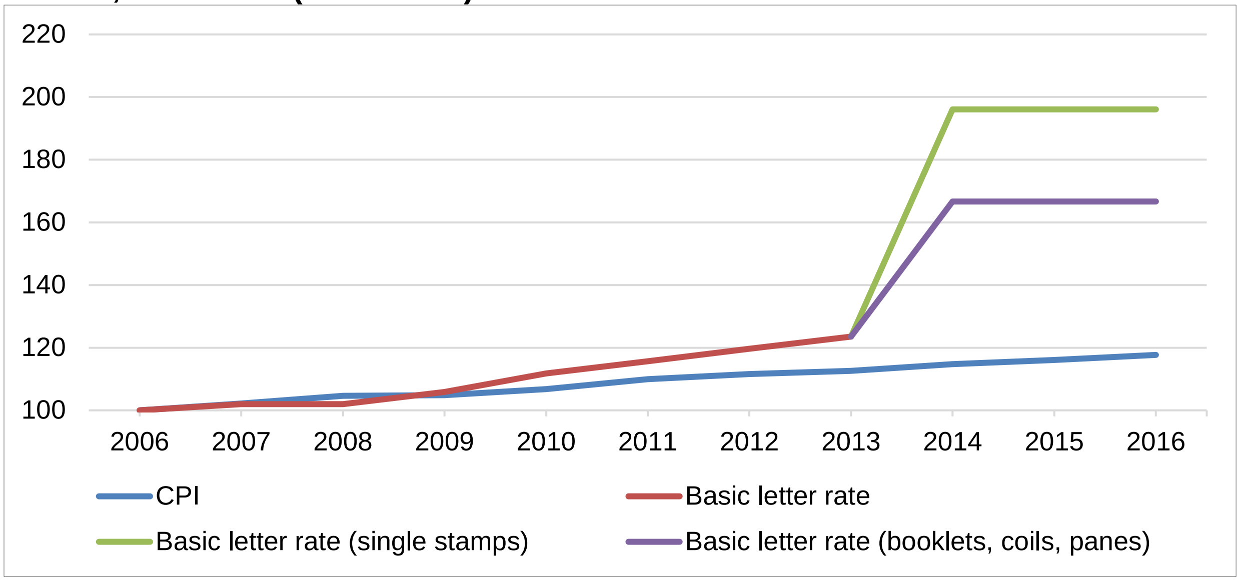
These trends of increasing pricing flexibility and above-inflation price increases are not unique to Europe. In Canada, the basic letter price increased 66.7-96.1 percent between 2006 and 2016, while consumer inflation rose only 17.7 percent.[321] The basic letter price increased on average by 5.6-8.0 percent per year, while consumer inflation increased only 1.6 percent.[322] As the chart below shows, and as discussed further in Appendix F, the decade-average growth rates for the basic letter rate mask the fact that prices have grown at an even faster inflation-adjusted rate since Canada's inflation-based price cap was repealed in 2009.[323]

[321] For Canada Post's prices, see Canada Post Corp., Postal Prices: Canada, U.S.A. and Other Countries (Jan. 2006) (CAD 0.51), *available at* https://www.adminware.ca/checklist/cp_rates-06-01s.pdf, and Canada Post Corp., Press Release, 2016 Regulated Postage Stamp Rates to Remain at Current Levels (Dec. 15, 2015) (CAD 0.85 for stamps purchased in booklets, coils, or panes, and CAD 1.00 for stamps purchased individually), http://tiny.cc/CPC-2016-rates. For consumer inflation, see Statistics Canada, Table 326-0021, Consumer Price Index, annual (2002=100), *available at* http://www5.statcan.gc.ca/cansim/a26?id=3260021&retrLang=eng&lang=eng (last visited Feb. 1, 2017).

[322] These figures represent the arithmetic mean of annual changes between years, based on the same data sources as the previous footnote and Robin Harris, Canadian Philately: Canadian Postal Rates, https://www.adminware.ca/checklist/chk_rate.htm (last updated Feb. 12, 2015).

[323] Appendix E at 24 ("Overall, since the discontinuation of [Canada's] CPI-based price cap, basic postage rates increased 63.5% (if stamps were not purchased singly) while the CPI increased 12.5%.").

Chart 17: Comparison of changes in basic letter prices and consumer inflation in Canada, 2006-2016 (2006 = 100)[324]



Finally, in Australia, the basic letter rate has increased by 40-100 percent in the last decade, while consumer inflation has grown by only 24.9 percent.[325] The basic letter price increased on average by 7.9 percent per year, while consumer inflation increased only 2.3 percent.[326] The decade average is somewhat misleading: like the Postal Service before the PAEA, the Australian Postal Corporation's (Australia Post's)

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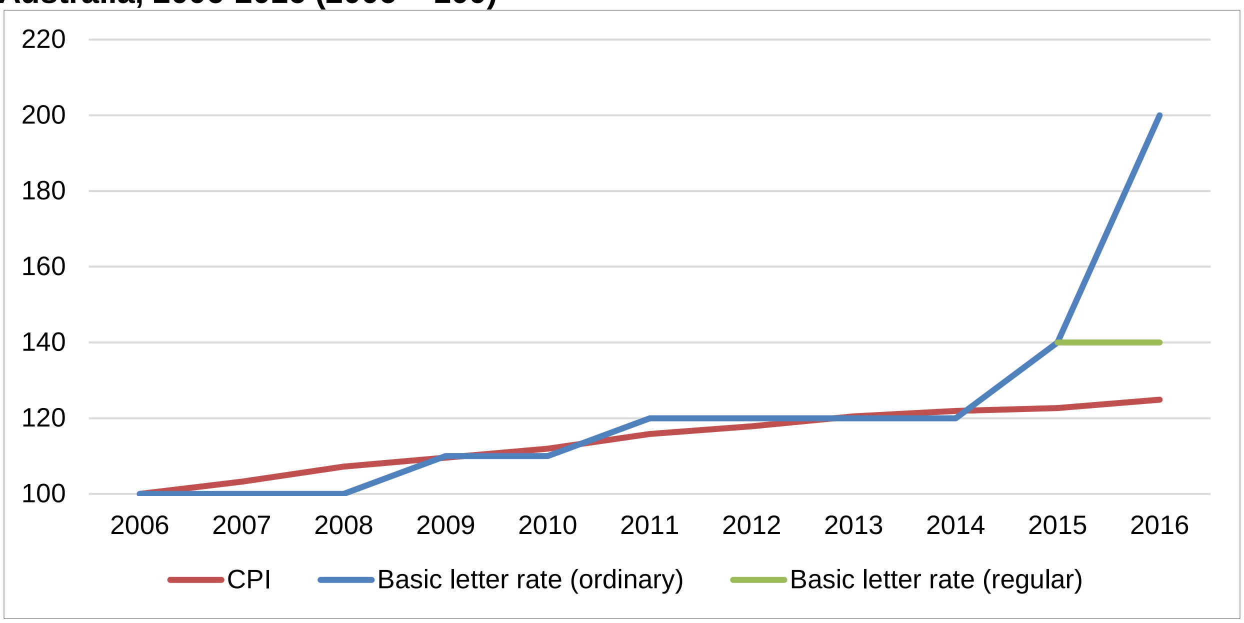
[324] Data on this chart is drawn from the same sources as the preceding footnotes, with all data sets calibrated to a base year of 2006.

[325] In 2006, the basic letter price was AUD 0.50; by 2016, it was AUD 0.70 for a "regular" letter and AUD 1.00 for an "ordinary" letter. *See* Australian Competition & Consumer Comm'n (ACCC), Australia Post – Letter Pricing 2015, https://www.accc.gov.au/regulated-infrastructure/postal-services/australia-post-letter-pricing-2015; ACCC, Letter Pricing 2002, https://www.accc.gov.au/regulated-infrastructure/postal-services/letter-pricing-2002. The prices set in 2002 remained in effect through 2006. Through 2015, the basic letter service was known as "ordinary" letters. In 2016, Australia Post introduced the "regular" letter service at the same price as the previous "ordinary" letter rate, but with slower delivery standards. "Ordinary" letters offer the same delivery standards as before but are now priced higher. For consumer inflation, see Australian Bureau of Statistics, 6401.0 – Consumer Price Index, Australia, Tables 1 and 2, CPI: All Groups, Index Numbers and Percentage Changes (Jan. 25, 2017), *available at* http://tiny.cc/ABS-CPI. This inflation statistic reflects the index as of December of each year.

[326] These figures represent the arithmetic mean of annual changes between years, based on the summaries of "Letter pricing" proceedings for the relevant years at ACCC, Regulatory Projects: Postal Services, http://tiny.cc/ACCC-projects (last visited Feb. 1, 2017), and the CPI data referenced in the preceding footnote.

price increases tended to track inflation through 2013, and the entirety of above-inflation increases occurred in 2015-2016. In 2015 and 2016, the "ordinary" letter price was allowed to increase by 16.0 percent and 41.1 percent above inflation, respectively.[327] In consenting to these significant above-inflation price increases, the Australian Competition and Consumer Commission (ACCC) cited volume declines due to electronic substitution and the fact that the resulting revenues still would not cover Australia Post's costs (much less raise a regulatory concern of excessive profits).[328]

Chart 18: Comparison of changes in basic letter prices and consumer inflation in Australia, 2006-2016 (2006 = 100)[329]



These foreign experiences also demonstrate that pricing flexibility is not bestowed only after postal operators have exhausted their efficiency potential. Indeed,

[327] Per the sources in the preceding footnotes, in 2015, the basic letter price rose from AUD 0.60 to AUD 0.70 (16.7 percent), compared with 16.0 percent CPI. In 2016, the basic price for an "ordinary" letter rose further to AUD 1.00 (42.9 percent), compared with 1.8 percent CPI.

[328] ACCC, Decision on Australian Postal Corporation 2015 Price Notification (Dec. 9, 2015), Attachment A at 6-7, http://tiny.cc/ACCC-2015-decision; ACCC, Decision: Australia Post Price Notification for Its "Ordinary" Letter Service (Feb. 20, 2014), at 32-33, http://tiny.cc/ACCC-2014.

[329] Data on this chart is drawn from the same sources as the preceding footnotes, with all data sets calibrated to a base year of 2006.

many of them appear to lag the Postal Service in key efficiency initiatives. As discussed in section IV.A.5.a above, the Postal Service has consistently ranked as the most efficient postal operator among industrialized countries. For instance, the Postal Service's early start on automation, particularly in a time of more favorable market conditions, arguably made it better "able to adapt the postal pipeline at a more gradual pace to increase efficiency and cost flexibility[, and made it] better prepared [than some of its postal-operator peers] to face the overall demand decrease in 2008."[330] The Postal Service was the first postal operator in the world to automate delivery sequencing (Royal Mail and La Poste followed more than a decade later), which has allowed it to reduce its delivery-unit footprint by 35 percent between 2008 and 2014, compared with 0 percent for Royal Mail.[331] As of last year, approximately 10 percent fewer Royal Mail letters than Postal Service letters, proportionally, received automated delivery sequencing, which has allowed the Postal Service to reduce the proportion of its letter carriers' in-office time to half that of their U.K. counterparts.[332] Even as postal regulators have acknowledged further room for efficiency improvement (arguably exceeding that of the Postal Service), this has not deterred them from finding efficiency progress to be broadly sufficient to allow or sustain above-inflation price increases.[333]

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[330] WIK-Consult, Review of the Projected Costs Within Royal Mail's Business Plan at 74.

[331] *Id.* at 48, 53. The comparison is even more dramatic with Australia Post, which had not begun to automate delivery sequencing of letters as of 2015. ACCC, Decision on Australian Postal Corporation 2015 Price Notification, Attachment A at 21.

[332] WIK-Consult, Review of the Projected Costs Within Royal Mail's Business Plan at 36, 38, 48 (noting that Royal Mail sequences 82 percent of letters, compared with 90-95 percent among all other countries studied other than France, and that the proportion of in-office time is 40 percent at Royal Mail, compared with around 20 percent at the Postal Service). Royal Mail is also the only one of the studied postal operators that still sorts parcels by hand. *Id.* at 35, 50.

[333] Ofcom, Review of the Regulation of Royal Mail: Consultation Document (May 25, 2016), at 4, 6-7, 47-48 & Annex 5, https://www.ofcom.org.uk/__data/assets/pdf_file/0028/78184/review-of-royal-mail-

Current letter market pressures are such that, far from being viewed as mutually exclusive, both efficiency improvements and above-inflation price increases are needed in tandem.[334]

In sum, there is a near-consensus among European, Canadian, and Australian postal authorities that postal prices cannot realistically be tied to household inflation in an environment of declining letter volumes and steady or growing fixed network costs. Except for in a vanishingly tiny number of small countries, all postal authorities recognize that postage prices must be allowed to rise significantly faster than inflation in order to ensure the future of universal postal service.[335]

2. A close examination of five countries provides concrete examples of regulatory flexibility in response to shared challenges.

As discussed in the preceding sections, the Postal Service shares its market and financial challenges with other postal operators, and the Commission shares its statutory objectives with other regulators. The Commission would do well to consider how other regulators have applied the same objectives to the same challenges. Appendix F offers six examples from five industrialized countries with relatively large, sophisticated postal markets.[336]

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regulation.pdf; ACCC, Decision on Australian Postal Corporation 2015 Price Notification, Attachment A at 15-22.

[334] Ofcom March 2012 Decision at 60 ("Given the wider considerations [i.e., volume declines and price elasticities] and Royal Mail's financial position, we consider that there should be inherent efficiency incentives as long as the regulatory framework does not distort the effectiveness of those incentives. A framework which constrains profits and focuses on form of price regulation rather than the underlying operational performance is most likely to have such an effect.").

[335] To be clear, this discussion of the specific increases imposed by foreign posts should not be construed as an indication of the specific magnitude of increases that the Postal Service would choose to implement if the current system were eliminated, and the proposal set forth in Section VI were adopted. The Postal Service has made no determinations about what sort of increases it would consider necessary, and any consideration of that issue is premature.

[336] These countries' postal regulatory models are also discussed in Appendix E.

Amid their diversity, these examples offer some clear lessons. The countries differ in their postal operators' legal status: two countries' postal operators (Canada and Australia) are government-operated entities with statutory monopolies, like the Postal Service; the other three (the U.K., France, and Germany) have substantial levels of private ownership and no statutory monopoly, albeit *de facto* near-monopoly status in their respective letter delivery markets. And the countries have different approaches to price regulation. Nevertheless, some common threads emerge:

- <u>Scope of regulated products:</u> Although the precise scope of regulation varies, every country except France limits price regulation to single-piece letters. The rationale is that single-piece mailers are generally individuals and small businesses with fewer options for reducing the impact of price increases. Single-piece mailers are therefore considered to be of greater regulatory concern than commercial mailers, who can often access bulk discounts, perform worksharing, and use their greater leverage to work out other accommodations with the postal operator.
- <u>Necessity of change and price true-ups to meet volume challenges:</u> In all five countries, the regulator has allowed significant above-inflation price increases as a necessary measure to place the postal operator on a more secure financial footing. Even those countries that have kept their price cap formulas thus far (France and Germany) have had to reopen and augment them with new flexibility measures. In none of these countries has a regulator persisted with a rigid price cap in the face of a postal operator's financial challenges from secular volume declines.

- Recognition that market pressures provide adequate discipline: The U.K. and Canada have abandoned rigid price caps in favor of greater deference to the postal operator's business judgment, and Australia has maintained a similarly flexible non-price-cap approach throughout recent history. In all three countries, as well as in France, volume declines have been recognized as serving as an inherent incentive for the postal operator to increase efficiency and to exercise restraint with respect to price increases.
- Recognition that monitoring can be effective to meet regulatory objectives: In the U.K. and Australia, postal regulators have coupled a lighter touch in the price-regulation area with comprehensive monitoring of the postal operator's efficiency, service quality, and finances. If efficiency or service quality lags unduly, or if prices or profits become unduly excessive, then the regulator may resume a more active stance in price regulation. This prospect serves as an additional deterrent on the postal operator's behavior. In a somewhat similar vein, the Canadian, French, and German postal regulators similarly monitor and discuss service performance and efficiency in qualitative terms when evaluating pricing proposals, rather than attempting to translate them into explicit pricing adjustments.
- Duration of regulatory periods: In no country does the postal regulator go an entire decade without re-evaluating the rate-regulation system. The French and German price controls typically last three or four years, as did those of the former U.K. regulator (although the U.K. system devolved into a series of one-year extensions). The current U.K. regulator has gone five years

between its reassessments of the regulatory system. After the abolition of its price cap, the Canadian government established one five-year pricing system, and then approved a new approach to pricing that has lasted three years.[337]

- Downsides of price cap regulation: The three price cap systems that attempted to account for the postal operator's business environment (France, Germany, and the U.K. before 2012) are necessarily complex. Each involves multiple factors and relies on forecasts of costs and volumes. The interplay of multiple factors dilutes the intended effects of each one, however, and reduces the predictability of prices overall. The use of forecasting increases the risk that reality will diverge from the forecasts, to the detriment of the postal operator attempting to maintain financial stability under the price cap. The French and U.K. regulators' attempts to address forecasting risk only added complexity and ultimately were ignored in recognition of the need for more sweeping pricing relief. In the end, all three price cap systems failed to keep up with radical changes in the business environment, and all three required significant revision or replacement.
- Price regulation only regulates prices: In no country are changes to products or mailing requirements regulated as price changes.

Again, the experience of these foreign postal systems is relevant because they serve similar regulatory objectives and have had to address similar challenges in the global postal business environment. The consensus lessons that arise from these examples

[337] Australia is not entirely relevant to this issue, as it does not have so much of a regulatory system as a case-by-case approach to reviewing annual price increase proposals.

supports the conclusion that a rigid, long-term price cap designed under 2006 market conditions is not enough to provide financial stability and meet other regulatory objectives in the post-recession era of secular volume declines. Drawing on these lessons, the Commission should adopt a model similar to Ofcom's, as discussed in the next section.

VI. THE COMMISSION SHOULD REPLACE THE PRICE CAP WITH A REGULATORY MONITORING APPROACH, SUPPLEMENTED BY A REQUIREMENT THAT THE POSTAL SERVICE PROVIDE FORWARD GUIDANCE OF RATE CHANGES

Given the clear failure of the current system to achieve the objectives (taking into account the factors), the Commission must proceed to consider what "modifications" or "alternative system" should be promulgated in order to achieve the objectives. Given the Postal Service's current precarious financial situation, as well as the challenges it faces moving forward, a system of regulatory monitoring by the Commission is the best way to ensure that the objectives are achieved moving forward.[338]

Under such a system, the Postal Service would be given the commercial flexibility over its market-dominant products to ensure that it can operate successfully in the current marketplace. Meanwhile, the Commission would comprehensively monitor the Postal Service's rates, costs, financial condition, cost reduction initiatives, efficiency improvements, and service performance to ensure that the objectives are being achieved. In addition, the Commission could impose a forward guidance regime that requires the Postal Service to give mailers notice regarding the timing and magnitude of rate increases at the class and product level, in advance of a specific rate filing. The

[338] As discussed in Section II.A.3 above, the Commission is clearly authorized to adopt whatever regulatory approach it considers most appropriate to achieve the objectives at this point in time; it need not maintain a (revised) price cap structure.

statutory structure is well-suited to the establishment of such a monitoring regime, which would accord with regulatory reforms that have occurred in the postal sectors of other countries.

While the Commission could theoretically attempt to design a more rational price cap system that seeks to correct the profound deficiencies of the current system, there is no reason to attempt such an exercise. A modified *ex ante* price control is fundamentally unnecessary to achieve the objectives, and it would be both complex and fraught with risk.

First, given the characteristics of the current postal marketplace the continuation of an *ex ante* price control is not necessary in order to achieve the objectives: the Postal Service has strong inherent incentives to operate efficiently and to only set prices at levels that are needed to ensure its financial sustainability, as well as strong inherent incentives to provide customers with appropriate rate predictability and stability.[339] A regime of monitoring and forward guidance would therefore ensure that these objectives are achieved. To be sure, Congress thought that a price cap system would be appropriate at the time the PAEA was enacted, in order to ensure a continued focus by the Postal Service on achieving efficiency gains that had begun in earnest when contribution-weighted volume peaked in the early 2000s. In the current environment, however, there is simply no longer a need to retain a price cap in order to ensure that these objectives are achieved. Moreover, the combination of a forward guidance regime and no *ex ante* price control would provide mailers with a robust level of predictability regarding the time and magnitude of future rate increases.

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[339] Nor is the retention of a price cap system necessary in order to take into account any of the factors.

Second, attempting to design a price cap system that could theoretically achieve the objectives would be complex and fraught with risk, particularly given the uncertainty in the postal marketplace and the sensitivity of the Postal Service's financial position to the assumptions that the Commission would use to design an alternative cap. The experiences of foreign postal regulators demonstrate this, as discussed in section V.B.2 above and Appendices E and F. The signal example is the U.K., where Ofcom's 2012 reforms gave Royal Mail the commercial flexibility to achieve the financially sustainable provision of universal service, as well as the direct oversight and incentives to ensure efficiency and service quality: all goals that Postcomm's complex price cap structure had failed to achieve. Given the fundamental lack of a need to impose a cap to achieve the objectives, there is no need for the Commission to explore Postcomm's failed path. Rather, similar to Ofcom, the Commission should design a regulatory regime that is characterized by monitoring, and should supplement that approach with forward guidance requirements to enhance predictability and stability.

A. Regulatory Monitoring Would Not Require the Commission to Conclude That the Postal Service Lacks Market Power.

As a threshold matter, a system predicated on regulatory monitoring would <u>not</u> constitute a finding (either explicit or implicit) by the Commission that the Postal Service lacks market power over market-dominant products, or that those products should be "deregulated." The Postal Service's market-dominant products would continue to be fully regulated in accordance with the terms of Section 3622 and the other provisions of the statute governing market-dominant products. Therefore, a system of regulatory monitoring would not mean that the Postal Service <u>lacks</u> market power under the statute. Rather, it would simply recognize that, given current circumstances, the Postal

Service has inherent incentives not to abuse any market power that it might have, and that a system of regulatory monitoring is fully capable of protecting against any risk of potential abuse. At any point, the Commission could step in if it concludes that the Postal Service is acting in a manner that is inconsistent with the objectives, and the Commission would have the ability to re-impose *ex ante* controls in the future if it determines that doing so is necessary. That prospect of regulatory intervention would serve as an additional check on the Postal Service.

The fact that a product is considered "market dominant" under the statute does not, of course, mean that the customers lack alternatives to the use of those products. Under the statute, a product is "market-dominant" if (1) it falls within the scope of the Postal Service's monopoly on the carriage of "letters," or (2) the Postal Service otherwise is deemed to have "sufficient market power" over the product.[340] However, as the Commission and all stakeholders recognize, businesses and individuals have ample non-mail alternatives for sending correspondence, conducting a transaction (e.g., sending a bill or making a payment), and advertising goods or services. While the statutory letter monopoly provides essential protection for the Postal Service's ability to sustainably provide universal service (by preventing cream-skimming competitive entry in the carriage of hardcopy letters), its existence certainly does not prevent customers from using substitutes to the mail. The same is true of other products on the market-dominant side as well: for example, Periodicals are not covered by the statutory monopoly, but the existence of Postal Service market power over physical delivery is of

[340] 39 U.S.C. § 3642(b). For the latter category, sufficient market power is defined as having an ability to "effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products."

increasingly diminished value, due to publishers' and consumers' shift from physical to electronic distribution of media content.

The existence of these alternatives to the mail is the fundamental challenge facing not only the Postal Service, but other posts as well, because they have resulted in a broad societal trend away from the use of the mail. As a result, not only does the growth in households and the economy fail to generate the levels of mail volume growth that it once did, mail volume levels are in an absolute decline. The existence of these alternatives necessarily has important implications for the Postal Service's financial condition, and, in turn, for its incentives to ensure that the mail remains as attractive a medium as possible for commerce and communications, as discussed further below.

By recognizing that these alternatives exist and have important implications for the Postal Service's incentives (and hence for the design of a regulatory system for market-dominant products), the Commission would not be concluding that the Postal Service lacks market power, as defined in the statute, over those products. The Commission would not, therefore, be acting in a manner inconsistent with how it has interpreted Section 3642.[341] Unlike express and parcel products, the substitutes to products remaining on the market-dominant side are for the most part "non-shipping

[341] Consistent with that provision, products covered by the statutory monopoly regarding the delivery of "letters" would continue to be regulated under Section 3622. Furthermore, the Commission has rejected the transfer to the competitive side under Section 3642 of one product (the round trip DVD mailer) not covered by the letter monopoly, holding that (1) the existing electronic and other alternatives are not sufficiently close and interchangeable to that product for purposes of establishing the relevant product market; and (2) the Postal Service exercised market power over the relevant product market, considering that delivery providers like UPS or FedEx do not provide a comparable product for the delivery of physical DVDs. Order No. 2306, Order Denying Request, PRC Docket Nos. CP2013-75 & MC2013-57 (Dec. 23, 2014), *aff'd by* United States Postal Serv. v. Postal Regulatory Comm'n, 816 F.3d 883 (D.C. Cir. 2016).

alternatives," rather than products of delivery providers like UPS or FedEx.[342] Indeed, as noted below, demand for these products remains inelastic, indicating that the reason for the decline in volumes and increased usage of electronic alternatives is not due to increased price sensitivity, but to non-price factors that are reducing usage of the mail.[343]

However, there is a critical difference between determining whether the Postal Service has market power, and how the exercise of that market power should be regulated by the Commission to achieve the objectives under Section 3622. By employing a monitoring approach, the Commission would simply be recognizing that the Postal Service's continuing market power requires some form of regulation to ensure achievement of the objectives under Section 3622 and guard against abuses of that market power.[344] However, the Commission would also be recognizing that an *ex ante*

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[342] Certain exceptions exist: for example, First-Class Mail Parcels, which is the subject of a pending transfer request. *See* United States Postal Serv. v. Postal Regulatory Comm'n, 842 F.3d 1271, 1273-74 (D.C. Cir. 2016) (distinguishing the round-trip mailer case, in which "the Postal Service had acknowledged that no other shipping companies offered a comparable product, but it nevertheless contended that it lacked market power due to competition it faced from non-shipping alternatives" from cases in which competition from shipping providers like UPS and FedEx exists).

[343] *See* Order No. 2306 at 18 (noting that "[m]arket definition, therefore, focuses on demand substitution, *i.e.*, on the extent to which customers would substitute away from a product in response to a price increase"). *See also U.S. Postal Serv.*, 816 F.3d at 886 (noting the Commission's finding that "the shift toward streaming may have nothing to do with price sensitivity of DVD-by-mail customers; it may just as well result from broader market trends unrelated to price-based substitution"); Timothy F. Brennan & Michael A. Crew, *Gross Substitutes Versus Marginal Substitutes: Implications for Market Definition in the Postal Sector*, *in* TIMOTHY F. BRENNAN & MICHAEL A. CREW (EDS.), THE ROLE OF THE POSTAL AND DELIVERY SECTOR IN A DIGITAL AGE 2-10 (2014) (noting that while "Internet competition has had a major impact on the demand for postal services, particularly letter delivery," this fact does necessarily imply that posts lack market power over the remaining (and much smaller) market for letter delivery, such that changing its designation from "market-dominant" to "competitive" is appropriate, because there is an "important distinction . . . between gross substitutes that reduce demand for a [post's] services, and marginal substitutes, where the effect on a [post] depends significantly on a [post's] prices").

[344] Therefore, a system predicated on regulatory monitoring would not constitute a treatment of products on the market-dominant side as being essentially competitive, rather than market-dominant. On the competitive side, prices are regulated solely through a series of price floors, to ensure that competitive products generate sufficient revenues to cover their costs (both collectively and individually) and make an Commission-determined "appropriate" contribution to institutional costs. 39 U.S.C. § 3633. There are no

price control is not necessary to do so in light of current business conditions. In this regard, the Postal Service's current market position is no different from other posts that do not have *ex ante* price controls, as discussed above.[345]

B. The Postal Service Has Strong Inherent Incentives to Keep Rates as Low as Possible and to Operate in an Efficient Manner.

Basic purposes of an *ex ante* price control are to ensure that a regulated entity with market power does not earn excessive profits and has the incentive to increase efficiency.[346] However, current market realities do not justify an assumption that a price cap is needed to guard against market power abuses, excessive profits, or inefficient management practices. The Postal Service is under greater pressure than ever before to ensure that the mail remains as attractive a medium for communication and commerce as possible, given the significant declines in contribution-weighted mail volume and its continuing reliance on mail volume to provide the economies of density that underlie the financially sustainable provision of universal service. While gross substitutes (e.g., electronic communications channels) may not mean that a post lacks market power, the fact that such market power is exercised over a smaller market means that it is much more difficult for the Postal Service to sustainably cover the costs of providing universal service. This, in turn, means that the Postal Service has strong

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statutory provisions that govern maximum rates on the competitive side, or that require the Postal Service to price in a predictable and stable way. By contrast, market-dominant products would continue to be subject to regulatory monitoring and forward guidance requirements by the Commission to ensure that these and other objectives specified in Section 3622 are being achieved.

[345] In particular, the Postal Service's current market position is no different from the other posts considered above that are not subject to a price cap system, which either have statutory monopolies over the delivery of letter mail (Australia and Canada) or lack a statutory monopoly but still have a dominant position in end-to-end and final-mile letter delivery (the U.K.).

[346] *See, e.g.*, Appendix E at 14. *See also* Ofcom March 2012 Decision at ¶ 6.40 (noting that "the aim of a price control was to ensure that private operators were not able to make excessive profits and to provide efficiency incentives in markets where competition was not sufficient to restrain pricing").

inherent incentives to (1) set prices only at the levels necessary to ensure financial stability (i.e., without seeking excess profits), and (2) aggressively pursue efficiency gains within the constraints of the law under which it operates. As such, there is simply no rational basis to conclude that a price cap is necessary to achieve those ends.

1. While the Postal Service can use rate increases as a tool to ensure financial stability, it has no incentive to raise prices to generate excess profits.

The fact that the Postal Service is facing significant challenges due to declining volume does not preclude the Postal Service from using rate increases (even potentially robust rate increases) as one tool to address its financial situation moving forward.[347] Indeed, absent changes to the statutory structure under which it operates, the Postal Service would need to implement a substantial increase in order to sustainably cover its costs. At the same time, the Postal Service has no incentive to raise prices to excessive levels, in order to generate revenues beyond what is needed to ensure its financial stability. Rather, the Postal Service is inherently incented to pursue a pricing policy that balances current revenue needs against its longer-term viability, rather than to seek to exploit any market power that its elasticities suggest that it may have.

The Postal Service's price elasticities have been very stable over the past decades. They continue to show that demand for market-dominant products remains inelastic, such that rate increases would be expected to improve the Postal Service's financial position. While various parties have taken the position that the elasticities are

[347] As noted in section V.B.1 above, substantial rate increases have been employed by other posts to ensure financial stability amid comparable market challenges.

flawed and that market changes have rendered demand much more sensitive to price changes than the elasticities would indicate, there is no empirical evidence to bear out this hypothesis.[348] The Commission has also rejected arguments that the elasticities are invalid, finding in the exigent decision that "the Postal Service's model provides the most reliable available estimate of the likely impact on volume of the proposed rate increase."[349] Indeed, experience since the exigent increase was implemented supports the continued validity of the current elasticities: the demand response to the implementation of the exigent increase was consistent with the elasticities. This indicates that price elasticities have not changed appreciably over time on account of either increased electronic diversion or the Great Recession, and that reduced demand for the mail continues to be due to non-price factors (such as changing demographics and technological innovation), rather than increased sensitivity to postal rate increases.

However, the fact that the elasticities continue to show inelastic demand does not mean that the Postal Service has any incentive to seek to exploit its market power by

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[348] *See* Reply Statement of Thomas E. Thress on Behalf of the United States Postal Service, PRC Docket No. R2013-11 (Dec. 6, 2013), at 36-38 ("The Postal Service has tested this proposition [i.e., that the structural changes in the economy that have altered the relationship between mail volume and GDP over the years might also have changed the relationship between mail volume and price] empirically and has found no evidence that Postal price elasticities have changed over time, either because of increasing electronic diversion or because of the Great Recession.") [hereinafter "Thress Reply Statement"]. Other studies have similarly found no evidence that demand has become more elastic. *Id.* (discussing studies by Christensen Associates and Commission staff).

[349] Order No. 1926 at 156-57. The Commission also closed the recent mailer-initiated proceeding to consider elasticity issues without issuing a notice of proposed rulemaking. In doing so, the Commission observed that "neither the commenters nor respondents to the [Notice of Inquiry] provided a new postal demand model to replace the current Postal Service's demand model," and that "there is no indication that issuing a notice of proposed rulemaking based on these proceedings would result in an improvement in the quality, accuracy, or completeness of the data or analysis of data contained in the Postal Service's annual periodic reports to the Commission." Order No. 3100, Order Closing Docket, PRC Docket No. RM2014-5 (Feb. 26, 2016), at 9. The Commission did note that it "supports the Postal Service's ongoing efforts to improve its current demand models." *Id.* at 11.

raising market-dominant rates by more than is necessary to ensure its financial stability. First, even if the Postal Service had any reason to attempt to generate excess profits (which, as discussed below, it does not), there is always the theoretical possibility that the Postal Service's elasticities would not accurately predict the demand response to very significant rate increases under current circumstances.[350] Various mailers have previously pointed out that because the CPI-U cap has largely kept real prices level since the PAEA was enacted (and hence before the onset of the "new normal"), it is uncertain how rate changes that depart significantly from inflation levels would affect mail volumes in the current marketplace.[351] During the exigent case, the Postal Service's volume forecasting witness agreed that this is a valid theoretical concern (while noting that it was not applicable to the exigent increase, which increased rates at a modest level well within the range of historic rate increases underlying the elasticities).[352]

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[350] The elasticities are calculated on the basis of historic data, and are also calculated at a relatively broad level.

[351] *See, e.g.*, Comments of the National Postal Policy Council [NPPC] et al. in Opposition to Exigent Rate Increase, PRC Docket No. R2013-11 (Nov. 26, 2013), at 36-38 (arguing that, because "real prices have changed very little over the past six years, the Postal Service's price-elasticity estimates over that time do not provide useful insights of how volume would change in response to larger real price changes" under current circumstances, considering that the "market in which [the Postal Service] operates today differs greatly from that of 2006 or earlier years" due to the "rapid improvements in alternative means of communication since 2006 or 2007"). The mailers presented the same argument in Docket No. RM2014-5.

[352] Thress Reply Statement at 36-38 ("Mr. Buc then notes the relatively narrow range over which real Postal prices have varied, especially since the enactment of the PAEA, and suggests that this might cause the econometric results to be unreliable for predicting the impact of larger-than-inflation rate increases. Mr. Buc correctly explains the issue on page 6, when he says, '[w]hen the values of an independent variable are tightly clustered, there is little predictive power in the relationship of the dependent variable and the independent variables outside of the range of independent variables used in the estimation procedure.' <u>While this is a valid theoretical point, it is not, in fact, applicable to the present case.</u> The rate increases being proposed in this case are sufficiently modest and the sample periods over which the Postal Service's demand equations are estimated are sufficiently long that, in fact, real after-rates prices in this case fall well within 'the range of independent variables used in the estimation procedure' as shown in Table 5." (emphasis added)).

Therefore, the greater the amount by which rate increases deviate from the levels seen in recent years, the more uncertainty exists as to whether an unanticipated demand response could occur in the current "new normal" marketplace. This, in turn, inherently incents the Postal Service to seek to restrain price increases only to the extent necessary to ensure its financial stability.[353] Of course, to the extent that any unexpected demand response occurs, it could lead to another significant level shift in volumes that could be financially devastating for the Postal Service, as it could reduce overall revenues and exacerbate the Postal Service's declining economies of density. Additionally, the risk of an unexpected demand response could be asymmetric, in that any volume that leaves the postal system as a result of an excessive price increase would not generally return even if the increase was thereafter reversed. Hence, the Postal Service would have no confidence that, if it sought to increase rates to an excessive level, it could successfully counteract any unexpected volume response that occurs by later pulling the rates back to appropriate levels.[354]

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[353] To take one example, regarding Presort First-Class Mail, it is fair to say that businesses generally prefer that bill presentment and payment channels be electronic because that is a much lower-cost channel than using the mail; this, in turn, indicates that the continued use of the mail is "mainly a matter of customer preference." Thress Reply Statement at 40. Indeed, the most recent Household Diary Study estimates that while a significant portion of bill <u>payment</u> migrated to electronic means from 2005 to 2015, the growth in electronic bill <u>presentment</u> has been much more gradual. The Household Diary Study: Mail Use & Attitudes in FY2015 at 3 (2016) ("The Internet also contributed to a decline in the number of bills households received through the mail. Unlike bill payments, however, the pace of migration to the Internet for bills continues at a relatively slow pace. Over the last ten years (2005 to 2015), the share of bills received online increased gradually from 3 percent to only 17 percent.") [hereinafter "FY2015 Household Diary Study"]. Theoretically, while bulk First-Class Mail senders of bills may be willing to accommodate customer preferences if postage rates stay at certain levels, attitudes could change if the Postal Service sought to increase prices to excessive levels, thereby leading to an unexpected demand response. Similarly, excessive rate increases for Marketing Mail could theoretically alter customers' assessment of the comparative strengths and weaknesses of direct mail relative to other advertising channels. Finally, Periodicals have been declining sharply in recent years due to declines in printed media, and the Postal Service has no incentive to further drive those customers from the mail through excessive increases.

[354] Mailers have also noted the same expectation. *See, e.g.*, Initial Comments of Greeting Card Association, PRC Docket No. R2013-11 (Dec. 3, 2016), at 22-23 ("The problem is particularly acute in this

Moreover, the Postal Service has no organizational incentive to seek to exploit its market power in an attempt to generate excess profits. The Postal Service has no shareholders, who might expect or demand the maximization of profits in the short-term.[355] This factor means that the Postal Service has no real incentive to seek short-term profits through excessive price increases at the expense of the longer-term achievement of its statutory mission.[356] Rather, retained earnings are expressly allowed under the statute to ensure that the Postal Service would not be inhibited from generating funds to support capital investment, fund network expansion, and generally ensure the long-term sustainability of the business.[357] In any event, the transparency

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case, because electronic diversion is not an instance of reaction to price exclusively. It is generally agreed that a customer who switches from paper mail to e-media will not switch back, more or less regardless of postal price changes. This is presumably true even if the initial switch is motivated, or partly motivated, by a postal price increase."). *See also* Ofcom, Review of the Regulation of Royal Mail (Mar. 1, 2017) [hereinafter "Ofcom March 2017 Review Decision"], at ¶ 3.123, http://tiny.cc/Ofcom-03-17-review (noting that "[t]he impact of e-substitution in transactional mail (which accounts for nearly 50% of Royal Mail's letter revenue) is likely to be higher than advertising mail as it is unlikely to switch back to physical mail in the future (due to the very low incremental cost of electronic communication)").

[355] While the Postal Service lacks shareholders, it does not lack outside oversight to hold the Postal Service to account for its financial and operational performance, as discussed below. Such oversight comes not only from the Commission, but from outside bodies like Congress, GAO, and the Office of the Inspector General (OIG). Furthermore, the Governors also oversee Postal Service management.

[356] *See also* U.S. Postal Service Office of the Inspector Gen., RARC-WP-11-001, Fundamental Questions for the Future of the Postal Service (2011), at 9 ("In fact, the Postal Service has no residual claimants like shareholders to benefit from profitability, so there is little incentive for the Postal Service to seek profitability at the expense of its mission.").

[357] *See* S. REP. NO. 108-318, at 8 ("[T]he ability to retain earnings will provide the Postal Service with revenues necessary to fund network expansion and necessary capital improvements."). *See also* U.S. Postal Serv., Transformation Plan ix, 71-72 (2002) (proposing to allow retained earnings "to finance the expanding delivery network, decrease outstanding debt, and fund investments in technology," as well as to "enable the Postal Service to get through temporary economic slowdowns without always having to raise prices, allowing it to focus more on the longer term"). While at certain points it was suggested that retained earnings could also be distributed to executives or employees as bonuses, H.R. REP. NO. 109-66, pt. 1, at 43-44 ("The bill encourages innovation and efficiency by permitting the Postal Service to distribute earnings as bonuses to all employees."), the legal provisions governing compensation in the Postal Service would inhibit the use of excess profits for such a purpose. 39 U.S.C. §§ 202(a)(1), 1003(a), 3686. In any event, given the challenges facing the Postal Service, there is simply no plausible basis to assert that the Postal Service might seek to exploit its market power in the short term in order to generate excess earnings that could jeopardize its continued survival as a self-sufficient entity in order to distribute such earnings as bonuses.

required by the PAEA would make it quickly evident whether the Postal Service was earning excess profits, and the Commission would be able to step in, meaning it would be wholly irrational for the Postal Service to pursue such an approach.

Ofcom has recognized that simply because a post may continue to have market power does not mean that it will feel free to seek excessive price increases in the current marketplace, particularly if a monitoring regime is in place. As with the Postal Service, Royal Mail's elasticities indicate inelastic demand. However, Ofcom in 2012 rejected arguments that this fact necessitated an *ex ante* price control in order to protect customers from abuse of Royal Mail's market power, finding that while rate increases were necessary to address Royal Mail's then-precarious financial situation, "Royal Mail has a commercial incentive to ensure that such price rises do not significantly accelerate market decline and therefore threaten the viability of the universal service."[358] It therefore considered that a monitoring approach would protect customers from excessive price increases.

Ofcom reiterated this view in its recent decision to retain a regulatory monitoring approach, finding that while Royal Mail has market power, given its dominant position in delivery of letters (particularly considering the exit of Whistl from the end-to-end market) and the inelastic demand indicated by its elasticities,[359] Royal Mail's pricing behavior did

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[358] Ofcom March 2012 Decision at ¶ 6.7.

[359] Ofcom March 2017 Review Decision at ¶¶ 3.104 (noting that Royal Mail is a "near monopolist" on single-piece services); 3.105 (noting that "Royal Mail provides the overwhelming majority of bulk letter mail delivery (>99%) and there was little prospect of any significant future entry"). Ofcom therefore found that "the constraints Royal Mail faces are unlikely to be sufficient to prevent it from raising prices in many sectors of the postal market," finding in particular that "Royal Mail has not provided any evidence to suggest that price increases in letter mail have had a significant impact on e-substitution." As noted above, the Postal Service is not arguing here that it lacks the ability to raise rates on the market-dominant

not indicate any attempt to abuse that power. Indeed, after Royal Mail has raised prices significantly in order to restore profitability,[360] Royal Mail has thereafter been pricing at a moderate level for all types of mail, meaning that it "had not raised prices as much as we considered it could profitably have sustained."[361] Therefore, Ofcom stated that while Royal Mail may continue to have market power, "the challenges of structural letters decline as a result of e-substitution . . . appear to provide some constraint on its pricing behavior."[362] It also noted that "political pressure, negative publicity and our monitoring regime act as additional constraints on Royal Mail's pricing of single piece letters,"[363] while, for bulk mail, "Royal Mail may be subject to more competitive constraints in relation to advertising mail and that other factors, such as our monitoring regime and the impact of price shocks on e-substitution, may provide some constraint on its pricing behaviour."[364]

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side; rather, the Postal Service lacks any incentives to exploit its market power, by raising prices excessively.

[360] *Id.* at ¶ 3.111 ("What we do know, looking at the decline in overall UK letter volumes over the last five years, is that the rate of decline was higher in 2011-12 and 2012-13 following significant price increases by Royal Mail. However, this has resulted in increased letter revenue for Royal Mail which suggests that these price increases were profitable for Royal Mail."). However, Ofcom did note the possibility that the while these significant rate increases may not have impacted electronic diversion trends in the short term, there was the possibility of a longer-term impact that would only become evident over time. *Id.* at ¶ 3.112.

[361] *Id.* at ¶ 3.104.

[362] *Id.* at ¶ 3.173.

[363] *Id.* at ¶ 3.118.

[364] *Id.* at ¶ 3.127. *See also id.* at ¶ 3.105 ("We also considered that the threat of a large increase in e-substitution may constrain Royal Mail from increasing prices substantially above current levels, and that pricing constraints may vary by application (e.g. there may be greater competitive constraints from other media in relation to advertising mail). However, we provisionally concluded that Royal Mail was likely to be able to unilaterally and profitably raise prices for some bulk mail letter services and a number of other factors (such as our monitoring regime and the potential impact of further significant price increases following on from 2011-12 and 2012-13 leading to a step change in e-substitution) were likely to account for Royal Mail's relatively modest price increases since 2012.").

There is no basis for the Commission to draw a different conclusion regarding the Postal Service. If anything, because Royal Mail must generate a sufficient return to attract shareholders and private bondholders, it would logically have more of an incentive to seek to exploit any short-term pricing power that it might have.[365] However, Ofcom has concluded that it has not done so. By contrast, the Postal Service is free to take a longer-term perspective: it has no need to seek to maximize short-term returns at all, much less at the potential expense of the achievement of its statutory mission. As such, there is no rational reason to conclude that whereas a regulatory monitoring approach is appropriate for a post like Royal Mail, the Postal Service would, absent a price cap, decide to exploit customers by charging prices that seek greater earnings than is necessary to maintain financial stability, simply because its elasticities indicate inelastic demand for market-dominant products. This is one central reason why an *ex ante* price control is not needed.

Finally, even if the Commission were inclined to accept arguments that the elasticities are incorrect and mailers are more price sensitive than ever because of electronic alternatives, doing so would further justify why an *ex ante* price control is not needed.[366] A party cannot claim on the one hand that ample alternatives severely constrain the Postal Service's ability to raise rates, while on the other hand claim that a price cap is needed because mailers are "captive" customers who would have no choice but to accept excessive rate increases that the Postal Service sought to impose.

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[365] *Cf. id.* at ¶ 3.62 (noting that "Royal Mail's main objective is to maximize returns to its shareholders").

[366] Mailer stakeholders consistently assert that, because ample alternatives to the mail exist, rate increases by the Postal Service could simply exacerbate the Postal Service's financial problems by driving more volume away than the Postal Service's elasticities would indicate. Order No. 1926 at 148-154 (describing mailer arguments against exigent case on this ground).

2. The Postal Service has inherent incentives to be efficient in order to restrain price increases.

Another central reason why an *ex ante* price control is unnecessary is because the challenges presented by the "new normal" marketplace also provide the Postal Service with very strong incentives to seek efficiency gains within the constraints of its statutory structure, in order to restrain price increases by as much as it can, and therefore avoid any unexpected demand response that could occur due to unnecessary price increases. As demonstrated in section IV.C above, the primary motivating factor for the Postal Service to reduce costs and increase efficiency is <u>volume trends</u>, particularly declining First-Class Mail volumes per delivery point: the Postal Service was undertaking aggressive efforts to cut costs and improve efficiency well before the PAEA was enacted, meaning that the imposition of the price cap by the PAEA was not the causal factor for Postal Service's continued cost reductions and efficiency gains over the past decade. While Congress felt it prudent to impose a price cap in 2006, in order to ensure that the Postal Service maintained a sharp focus on reducing costs and increasing efficiency, there is simply no longer a need to maintain a price cap in order to achieve that goal.

First, as discussed in more detail in section IV.C above, a clear inflection point when it comes to the Postal Service's efforts to reduce cost and increase efficiency can be discerned well before the PAEA was enacted, by examining metrics such as TFP, employee complement, and workhours. At the turn of the century, after it became evident that First-Class Mail volume was no longer tracking economic growth (and, in fact, was in absolute decline), the Postal Service began to undertake significant efforts to reduce costs and increase efficiency.[367] The Postal Service substantially reduced resource usage through labor and other cost reduction programs, which drove robust gains in TFP beginning in FY2000.[368] These efforts are also made clear when separately examining employee complement and workhours, both of which peaked in FY1999, and began to decline substantially thereafter.

The efficiency gains of the post-PAEA period therefore reflect a continuation of trends that began prior to the PAEA. While the pre-PAEA reductions occurred during a time in which workload was stable, volume declines rapidly accelerated following the PAEA. This accelerated decline in volumes, which compressed volume declines that were expected to occur over the long-term into a few short years,[369] in turn incented accelerated cost reduction initiatives and declines in resource usage, workhours, and employee complement.[370] There is no basis to conclude that the price cap itself was the driving factor behind these trends, as opposed to the same factor—volume—that had been motivating efficiency gains well prior to the PAEA. Instead, the effect of the

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[367] This is not to suggest that, prior to this time period, the Postal Service was making inefficient management decisions; indeed, one reason the Postal Service was able to achieve such strong productivity growth during this period was due to automated equipment investments and other infrastructure upgrades that occurred in the 1990s. Rather than requiring one to draw any specific judgments about that prior period, it is sufficient to recognize that, beginning with the peak in contribution-weighted volume per-delivery point and the Postal Service's subsequent efforts to reduce costs and increase efficiency, there is no reasonable question as to whether the Postal Service has had inherent incentives to be efficient since the early 2000s, regardless of the precise structure of the rate regulation system.

[368] Appendix D at 8 ("Between FY 2000 and FY 2006, the Postal Service had little workload growth but was able to reduce resource usage considerably and TFP increased at a robust 1.3% per year.").

[369] Order No. 1926 at 178.

[370] This includes initiatives like Network Rationalization, as well as the collective bargaining agreements (and subsequent arbitration awards) that increased the number of non-career employees and created a two-tier workforce.

price cap was to prevent the Postal Service from maintaining financial stability, despite its continued aggressive efforts to improve reduce costs and improve efficiency.

While, as discussed above, there was recognition prior to the enactment of the PAEA both of the challenges presented by declining First-Class Mail, and the initial efforts by the Postal Service to reduce costs and increase efficiency, Congress's decision to nevertheless impose a price cap as an interim measure in 2006 does not justify the continuation of a price cap in 2017. Conditions have fundamentally changed since enactment of PAEA, in a way that makes the Postal Service's situation exponentially more difficult than ten years ago. Indeed, as the Commission has stated, the level shift in mail volume that has occurred in the past decade has resulted in a "new normal," which is fundamentally distinct from the situation that existed when the PAEA was enacted.[371] Simply put, it is no longer relevant that Congress in 2006 felt it prudent to use a price cap to ensure that the Postal Service continued to focus on the need to improve efficiency. At that time, there had been only a relatively short period of sustained productivity growth, and the Postal Service was still delivering 213 billion pieces of mail per year. After a decade of dramatic and unforeseen volume declines and 17 years of sustained, aggressive efficiency savings, there is not a rational basis to conclude that a price cap remains necessary today to ensure that the Postal Service continues to aggressively pursue cost reductions and efficiency gains.

[371] Order No. 1926. As one piece of evidence of how the Postal Service's challenges have increased since 2006, the Household Diary Study estimates that "the share of bills paid by mail decreased from 67 percent in 2005 to only 30 percent in 2015." FY2015 Household Diary Study at 2. *See also* NPPC et al. Comments in Opposition to Exigent Rate Increase, PRC Docket No. R2013-11, at 37 ("the market in which [the Postal Service] operates today differs greatly from that of 2006 or earlier years.").

Moving forward, the challenges facing the Postal Service are significant, which inherently incents the Postal Service to continue aggressively pursuing initiatives that reduce costs and increase efficiency, including those initiatives within management control and those initiatives that require collective bargaining. The challenges of the Postal Service's current situation include the following:

(1) A highly precarious financial position, in which significant steps must be taken to restore the Postal Service to financial stability, in order to ensure its continued ability to fulfill its statutory obligations in a self-sufficient manner;

(2) The continued decline in market-dominant volume from current levels, driven by the secular decline of First-Class Mail (the product that provides the bulk of the Postal Service's contribution towards institutional costs) due to electronic diversion, even as delivery points continue to grow;

(3) An uncertain economic outlook, in which there is a clear possibility of a recession occurring sometime in the next ten years which could further reduce mail volumes;

(4) The fact that continued reductions in cost are now more challenging to capture than has been the case over the prior 17 years, considering the statutory structure under which the Postal Service operates; and

(5) The fact that the Postal Service's growth product is packages, which are more costly for the Postal Service to deliver, for which there is intense competition with a number of successful private sector firms, and for which uncertainty reigns

> about the Postal Service's continued ability to increase volume and contribution moving forward, given marketplace conditions.[372]

Regarding the fourth point, the Postal Service will, as it has in the past, continue to aggressively focus on reducing costs and increasing efficiency in order to ensure its ability to compete successfully in the current marketplace. As noted above, this is one of the Postal Service's fundamental obligations under the statute. Furthermore, as with any large organization, the Postal Service has identified opportunities for further cost reductions and efficiency gains, and is working aggressively to capture those savings. Indeed, as noted above, the A&M Report validates the Postal Service's continuous efforts to improve its efficiency, as the cost savings opportunities that the report identifies concern initiatives that the Postal Service has already been pursuing.

However, after 17 years of substantial efficiency gains and cost reductions, it must be recognized that the ability to achieve additional reduction in those costs that are within the Postal Service's control will be more difficult moving forward. The Postal Service is a labor-intensive organization, and it has been able to drive labor cost savings since the turn of the century primarily through reducing workhours and employee complement. Both of these sources of savings are now more challenging to capture, particularly at the levels previously achieved. For instance, after years of attrition and continuous headcount decline, the Postal Service's complement has grown slightly over the last couple of years as the delivery network grows and the number of packages (which are more costly to deliver) increases. Furthermore, while the cost of

[372] This is discussed in more detail in the Postal Service's filings in the appropriate share rulemaking, Docket No. RM2017-1.

current employees has been reduced through factors such as the increase in non-career employees and the imposition of a two-tier career workforce (which will drive significant savings in the future as older employees retire and new employees are hired), the ability to achieve additional reductions in this area is dependent on the outcome of future rounds of collective bargaining. While the Postal Service will continue to pursue favorable outcomes in collective bargaining and interest arbitration, the outcome of that process is inherently uncertain.

The Postal Service has also been able to achieve significant cost savings through reductions in the size of its retail, processing, and delivery networks through initiatives such as POStPlan, Network Rationalization, and delivery route optimization. While identified opportunities exist for further savings (such as moving forward with the process to identify whether there are any further Phase II network consolidation opportunities), significant additional reductions in network costs not already identified by the Postal Service could require further service level changes.[373] However, service level changes must be carefully assessed, to take into account whether they are consistent with the current postal needs of the American people, and whether they would prove counterproductive by reducing the value of the mail (and hence negatively affecting mail volume).[374] While the Postal Service will continue to evaluate the appropriate service levels moving forward, as noted above in Section IV there is no basis to conclude, at this point in time, that it is appropriate for the Postal Service to

[373] *See* Order No. 1926 at 118.

[374] *Id.* at 131, 134-35 ("Unlike a private enterprise, the Postal Service must consider the impact of its cost-cutting activities on its ability to continue to provide postal services consistent with the policies of title 39, United States Code.").

generate significant additional cost savings through further changes in service standards, or by changing mode of delivery, given existing conceptions of the appropriate levels of service.

The fact that TFP only grew by a small amount in 2015, and slightly declined in 2016, is not evidence that the Postal Service has lessened its efforts to continually reduce costs and increase efficiency. As an initial matter, as noted above, the Postal Service was focused heavily over the past two years in restoring service performance. Moreover, as Christensen Associates note in Appendix D, while prior cost reduction efforts serve to lower the cost base in subsequent years, "in order to continually increase TFP, the Postal Service must continue to find new ways to reduce costs."[375] Finding new ways to reduce cost can, in turn, be more difficult if a firm has already captured significant efficiency gains in prior years, particularly if it is subject to legal constraints that can inhibit its efforts.[376] Therefore, Christensen notes that:

> While the Postal Service productivity record since 2000 has been commendable, one cannot simply use that performance as a benchmark for future years. As mentioned above, the rate at which the Postal Service is able to increase TFP is dependent upon a number of factors which can change over time, including workload trends, capital investments, and the ability of the Postal Service to implement initiatives to capture additional cost savings. Over the past sixteen years, the Postal Service was able to make substantial progress in automating letter processing and mechanizing parcel sortation. These innovations made it possible for the Postal Service to reduce costs and increase TFP. A second factor that likely led to Postal Service TFP gains was the fact that the Postal Service was able to achieve significant flexibility in its utilization of its labor force through new contracts with its unions. These labor agreements have allowed the establishment of new "non-career" employee classifications, which allow the Postal Service to utilize their workforce in more flexible and less costly ways. The 2010 collective bargaining agreement with the American Postal Workers Union established a non-career category of

[375] Appendix D at 6.

[376] *Id.* at 5-6 & n.14.

> clerks called Postal Support Employees. Subsequent contracts with the National Association of Letter Carriers and the National Postal Mail Handlers Union established City Carrier Assistants and Mail Handler Assistants, respectively. By FY 2016, non-career employees made up 20% of the Postal Service workforce. While the Postal Service may be able to continue to substitute these non-career employees for retiring career employees over the next few years, the gains from these particular agreements will eventually diminish and new sources of productivity improvements will have to be found. While cost reduction initiatives like Network Rationalization will potentially create one-time increases in TFP, continued TFP growth will require additional initiatives in the future. Furthermore, the impact of such initiatives will need to be evaluated with regard to their impact on quality of service in order to conclude that those initiatives are in the public interest.[377]

Furthermore, as noted in section III above, Christensen Associates also notes that because TFP is a “top-down measure of operational efficiency,” it does not provide a benchmark to measure what would be “good” or “bad” TFP results in a particular year, and year-to-year variation is to be expected as the conditions facing a firm change.[378] Consequently, “[w]hen using TFP as an evaluation tool of management, it is important to look at TFP trends over several years rather than isolated annual TFP results.”[379] Thus, the Commission should not consider the prior two years of TFP trends as indicating that the Postal Service is no longer maintaining a focus on improving efficiency; rather, they reflect the need to restore service issues (precipitated by the rigidity of the current system) as well as the challenges the Postal Service faces in continuously improving TFP in the current marketplace.

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[377] *Id.* at 9.

[378] *Id.* at 5-10. One factor identified by Christensen that may suppress TFP growth in the short term but support it in the longer term is if a business finds itself in a position of having to “reorganize and shift their emphasis across different product lines.” *Id.* at 5. This phenomenon may be occurring with respect to the Postal Service today, considering packages are becoming a larger part of the mail mix.

[379] *Id.* at 6 & fn.15.

In sum, the evidence shows that the decline in mail volume provides the Postal Service with very strong incentives to reduce costs and increase efficiency. Given this fact, as well as the fact that the situation facing the Postal Service is considerably more challenging than what it faced in 2006, there is simply no longer any basis to conclude that an *ex ante* price control needs to be imposed in order to ensure that the Postal Service continues to aggressively seek to reduce costs and increase efficiency: the Postal Service <u>must</u> pursue such efforts in order to survive as a self-sufficient entity in a highly challenging marketplace. Therefore, now that 10 years has passed since the PAEA, and the marketplace has further evolved, the logical next step in the development of the market-dominant regulatory system is to replace the price cap with a regulatory monitoring structure.

In this regard, in addition to employing a regulatory monitoring approach based on a view that Royal Mail has no incentive to raise prices to generate excess profits, Ofcom also found such an approach to be appropriate on the basis that Royal Mail has inherent incentives to be efficient due to the structural challenges it faces from declining mail volumes. Ofcom found that this eliminates the need for an *ex ante* price control in order to incent efficiency gains.[380] Ofcom in 2012 noted that because of the volume declines challenging Royal Mail's financial stability, the continuation of the Postcomm

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[380] Like the Commission, Ofcom has a statutory duty to ensure that Royal Mail is operating efficiently. *See* Ofcom March 2017 Review Decision at ¶ 3.81 ("Ofcom has a duty to have regard to the need for the provision of the universal service to become and remain efficient. Given that efficiency can play an important role in ensuring that Royal Mail is able to continue providing a financially sustainable universal service, it is essential that the regulatory framework continues to provide appropriate incentives for Royal Mail to realise its potential to become more efficient. The framework should be such that Royal Mail is incentivised to make efficiency savings rather than rely on raising prices in order to achieve financial sustainability."). Hence, it cannot be claimed that the Ofcom model is an unsuitable comparison here because of any purported differences in how the respective statutory regimes prioritize efficiency improvements.

price cap was unnecessary because “Royal Mail has inherent efficiency incentives, given its financial position and the ongoing decline in market volumes.”[381] These “inherent efficiency incentives” meant that Royal Mail would not seek to address its significant financial challenges simply through price increases, but would also increase efficiency:

> We therefore proposed that a price control would not be appropriate or effective in the current context and would be unlikely to provide strong efficiency incentives in and of itself. Rather, we considered that Royal Mail would have inherent efficiency incentives. We concluded that we should remove price regulation in light of the prevailing market circumstances and because Royal Mail would retain incentives to become efficient, not just to increase prices.[382]

In its recent evaluation of the system, precipitated by Whistl’s departure from the end-to-end market along with the fact that Royal Mail has now restored itself to financial sustainability, Ofcom reaffirmed its earlier conclusion, finding that Royal Mail continues to have “strong incentives to improve its efficiency in future to remain financially sustainable,” given “[t]he challenges Royal Mail faces in the letter and parcel sectors.”[383] Therefore, Ofcom noted that there was no need to reimpose an *ex ante* price control in order to ensure that Royal Mail continues to pursue the necessary efficiency gains:

> Furthermore, we consider that the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. Our analysis, as set out in the May 2016 Consultation, indicates that there is scope for Royal Mail to make further efficiencies and we consider that the market conditions it faces incentivises it to pursue these efficiencies. For this reason, we remain of the view that Royal Mail is incentivised to pursue

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[381] Ofcom March 2012 Decision at ¶ 6.7. At the time, Royal Mail had negative EBIT margins.

[382] *Id.* at ¶ 6.8.

[383] Ofcom March 2017 Review Decision at ¶¶ 1.12, 3.69

> efficiency improvement despite its efficiency performance in 2015-16 being lower than that achieved in 2014-15.[384]

While Royal Mail has shareholders who expect a return on equity (which, as Ofcom notes, provides market discipline on its management),[385] this difference between Royal Mail and the Postal Service does not mean that Ofcom's conclusion regarding inherent efficiency incentives is inapplicable to the Postal Service. First, the evidence discussed above clearly demonstrates that "market conditions," in the form of the structural decline in First-Class Mail and other market-dominant volumes, give the Postal Service very strong incentives to be efficient. Indeed, as noted in section V.B.2 above, efficiency studies of the postal sector place the Postal Service ahead of Royal Mail in terms of efficiency.

Second, while the Postal Service lacks equity holders who might hold management to account for poor results, it is subject to extensive oversight regarding its performance, from various entities of its "shareholder," the U.S. Government: this includes the Commission, Congress, GAO, and OIG. None of these bodies lack access to the necessary information to assess the Postal Service's operational performance, or are reticent about identifying opportunities for improvement by the Postal Service. As such, the existence of these bodies means that the Postal Service is essentially subject to continuous oversight from highly activist "shareholders." In addition, internal oversight of the Postal Service's operational performance is provided by the Governors,

[384] *Id.* at ¶ 3.174.

[385] *Id.* at ¶ 1.17 ("We consider that market conditions and shareholder discipline are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation.").

who select and oversee Postal Service management. While the role of the Governors in overseeing management is perhaps under-appreciated, they play an important role in holding Postal Service management to account.[386]

C. A Price Cap Is Not Needed to Provide Predictability and Stability of Rates.

An *ex ante* price control is also unnecessary to achieve the "predictability and stability" objective. Rather, the elimination of an *ex ante* control, coupled with a requirement that the Postal Service provide forward guidance regarding rate changes, would fully achieve this objective.

As an initial matter, the ability of the Postal Service to rely on a schedule of regular, annual adjustments in a regulatory monitoring regime would invariably advance the purposes underlying this objective.[387] One of the central reasons for the dissatisfaction with the PRA system was that the peculiarities of the breakeven standard and the formal on-the-record hearing requirements meant that the Postal Service only raised rates through periodic omnibus rate cases. These cases were generally several years apart, and specific rate levels were not established until the end of the lengthy process, culminating in a Commission recommendation of rates that could deviate substantially from what was originally proposed by the Postal Service. Under this system, mailers complained that they had difficultly predicting what rates would result from a case, and about how rates would rise in a sudden and sometimes precipitous fashion.

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[386] While the Postal Service currently lacks Governors, that will not be a permanent situation.

[387] As discussed below, the restrictions of the current system has precluded the Postal Service from following such a rate change schedule, thereby reducing the predictability and stability of rates.

However, the Postal Service would, under a regulatory monitoring approach, be able to increase rates at regular intervals, rather than having to wait multiple years between increases as under the PRA. This would ensure that the Postal Service has the ability to avoid "sudden or extreme fluctuations" when it comes to rate increases, and hence to ensure the "stability" of rates. It would also give the Postal Service the ability to ensure that mailers are provided predictability regarding the timing and expected magnitude of increases, in order to appropriately plan for rate increases. In both respects, the Postal Service has no incentive to create dissatisfaction among its customers by setting forth increases that have not been anticipated, or that fluctuate in an extreme fashion on a year-to-year basis, and therefore make it more difficult to use the mail.

Furthermore, predictability within a regulatory monitoring regime can be ensured by the Commission establishing, as part of the new system, a regulatory framework under which the Postal Service would provide forward guidance regarding the timing and expected magnitude of rate increases, by class and by product, in advance of specific price change notices (which would continue to be provided on 90 days' notice). A forward guidance regime would enable mailers to anticipate and budget for rate increases, and would also provide another tool by which the Commission could monitor the Postal Service's behavior.

Forward guidance is a concept that is used by the Federal Open Market Committee of the Board of Governors of the Federal Reserve System ("FOMC") regarding the path of the federal funds interest rate, and is intended to influence market expectations.[388] It has largely been heralded as a success.[389] It has allowed market participants to anticipate the FOMC's actions, reduced volatility in the market, and has held the FOMC accountable for its goals.[390] It seeks to balance both flexibility and certainty in future actions, and thereby ensure that market participants have confidence that the guidance will be followed in the future.

To that end, the FOMC applies four principles when forming its forward guidance: transparency, predictability, flexibility, and credibility. Transparency and predictability require the FOMC to give the public a clear understanding of its objectives.[391] They are balanced with flexibility: forward guidance is not an unconditional commitment to a specific interest rate path, but is instead an expectation that is explicitly contingent on

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[388] Eric M. Engen, Thomas Laubach, and David Reifschneider, The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies 2 (2015), https://www.federalreserve.gov/econresdata/feds/2015/files/2015005pap.pdf. Forward guidance is a short explanation, typically only a few hundred words, which is included in the FOMC's statement released after its eight yearly meetings. Michael Feroli et al., Language after Liftoff: Fed Communication Away from the Zero Lower Bound 17 (U.S. Monetary Policy Forum 2016); Board of Governors of the Federal Reserve System, The Federal Reserve System Purposes & Functions: Conducting Monetary Policy 32, 36, https://www.federalreserve.gov/pf/pdf/pf_3.pdf.

[389] Jerome Powell, Governor, Board of Governors of the Federal Reserve System, Address at the 2014 Spring Membership Meeting, Institute for International Finance (June 6, 2014) [hereinafter "Powell Address"], https://www.federalreserve.gov/newsevents/speech/powell20140606a.htm.

[390] *See, e.g.*, *id.* Michael Feroli et al. provide the following example of how forward guidance fosters accountability: "[I]f monetary policymakers commit to an inflation objective of 2% then they know that they will be subject to public scrutiny and criticism if they miss this objective or pursue policies that are inconsistent with this objective. To avoid "embarrassment and possible punishment," they will be less tempted to pursue overly expansionary, discretionary policies in the short run that will be inconsistent with their commitment to the inflation target." Feroli, Language After Liftoff at 13.

[391] Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Address at the National Economists Club Annual Dinner, Herbert Stein Memorial Lecture (Nov. 19, 2013), https://www.federalreserve.gov/newsevents/speech/bernanke20131119a.htm; Jeremy Stein, Governor, Board of Governors of the Federal Reserve System, Address at the C. Peter McColough Series on International Economics, Council on Foreign Relations (June 28, 2013) [hereinafter "Stein Address"], https://www.federalreserve.gov/newsevents/speech/stein20130628a.htm; Feroli et al., Language After Liftoff at 53.

economic conditions.[392] At the same time, the efficacy of forward guidance is based on how credible market participants find the FOMC's commitment to following it: market participants will not conform their actions to forward guidance if they do not believe that it will be adhered to.[393] The FOMC establishes credibility and increases the effectiveness of forward guidance by being consistent with the assurances contained therein, even when deviation from those assurances would be more beneficial in the short-term.[394]

The Commission can effectively apply these principles to create a forward guidance regime that requires the Postal Service to provide to mailers with clear and credible expectations regarding the timing and magnitude of market-dominant rate increases, while at the same time retaining an appropriate level of flexibility to allow the Postal Service to respond to any unanticipated circumstances. A specific proposal regarding a forward guidance regime that could be established by the Commission is the following:

> **12 months before implementation:** Postal Service provides notice of its intent to change prices on a particular target date
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> **9 months before implementation:** Postal Service provides notice of the percentage changes in rates by class that it plans to implement, in addition to affirming or changing the initial target date (and explaining why any deviation is necessary)

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392 Stein Address; Janet Yellen, Vice Chair, Board of Governors of the Federal Reserve System, Remarks at the U.S. Monetary Policy Forum: Unconventional Monetary Policy and Central Bank Communications 3 (Feb. 25, 2011), https://www.federalreserve.gov/newsevents/speech/yellen20110225a.pdf.

393 Marc Labonte, Monetary Policy and the Federal Reserve: Current Policy and Conditions 15 (Cong. Research Serv. 2017), https://www.fas.org/sgp/crs/misc/RL30354.pdf; Taisuke Nakata, Credibility of Optimal Forward Guidance at the Interest Rate Lower Bound (Aug. 27, 2015), https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/credibility-of-optimal-forward-guidance-at-the-interest-rate-lower-bound-20150827.html.

394 Nakata, Credibility of Optimal Forward Guidance at the Interest Rate Lower Bound; Powell Address.

6 months before implementation: Postal Service provides notice of percentage changes in rates by product, and a list of structural changes, that it plans to implement, in addition to affirming or revising any prior forward guidance provided (and explaining why any deviations were necessary)

3 months before implementation: Postal Service provides notice of specific rates and any structural changes, including a discussion of how prices relate to forward guidance previously provided (with an explanation as to why any deviations were necessary)

Such an approach would provide a robust level of predictability that exceeds that which is provided by the current system in several respects.[395] First, regarding the timing of rate increases, the forward guidance regime would provide mailers with a year's notice of the Postal Service's intent to change rates at a given point in time, which, in conjunction with the elimination of an *ex ante* price control, would enable the Postal Service to follow a regular pattern of rate changes that mailers would have the ability to predict and plan for.

By contrast, the CPI-U regime has been characterized by much less predictability regarding the timing of rate increases, considering inflation has been low during much of the PAEA period (and even became negative for a period of time). While the first two increases under the PAEA occurred on a predictable pattern in 2008 and 2009, low and at times negative inflation thereafter prevented the Postal Service from maintaining that pattern in 2010; it was not able to raise rates again until 2011.[396] More recently, low

[395] The current system requires the Postal Service to maintain a "Schedule for Regular and Predictable Rate Adjustments" that sets forth the expected timing and magnitude of rate changes, which the Commission is required to display on its website. 39 C.F.R. § 3010.9. The current schedule states that rate adjustments are expected to occur in January of each year, "with the price increase for each market-dominant class equal, on average, to the applicable price cap limitation in that year." The Postal Service's proposal here is for a much more robust forward guidance approach that is one of the central elements of a revised regulatory regime.

[396] In the summer of July 2010, the Postal Service filed for an exigent increase, which it planned to implement in January 2011. At the time of the exigent request, available CPI authority was well below 1

inflation prevented the Postal Service from filing for a rate increase in 2016; instead, rates went down due to the expiration of the temporary exigent surcharge, an unprecedented see-sawing in Postal Service rate levels.[397] Clearly, then, the alternative regime proposed by the Postal Service would better enable the regular, predictable increases contemplated by Objective 2 than the current system.

Second, regarding the magnitude of increases, the proposed regime would also provide a robust degree of predictability, both at the class level and the product level. Regarding the latter, the current system does not provide mailers with the ability to predict specific increases at the product level until the Postal Service files its rate change notice. However, under the Postal Service's proposed framework above, forward guidance would be provided at a product level well in advance of a rate change notice.[398]

Moreover, regarding class-level predictability, the forward guidance provided by the Postal Service would provide mailers with a level of predictability that is not provided by reliance solely on CPI-U as a means to predict rate increases. Unlike the current system, forward guidance would provide mailers with the ability to anticipate the actual

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percent. After the Commission declined the request, inflation reached the point that the Postal Service was able to implement an increase in April 2011, 23 months after the prior increase.

[397] In particular, as discussed above, while the Commission found that an exigent surcharge to account for the losses due to the Great Recession was appropriate, it also held that upholding the principles of the current system required that the surcharge be temporary. By contrast, a flexible regulatory structure would avoid such a swing in rate levels, which was predicated not on business conditions but on restrictive legal mandates. Moreover, a more flexible structure would also reduce the litigiousness of the rate process, another potential source of unpredictability: because of the restrictions of the current system, and the financial instability it has wrought, there has been a great deal of litigation regarding the meaning of the exigent clause.

[398] The Postal Service would also provide the exact same level of predictability at the rate cell level, because the Postal Service would continue to provide notice of the specific rates 90 days before implementation.

rate levels that the Postal Service is committed to implementing (absent some fundamental change to the assumptions underlying the forward guidance). By contrast, CPI-U simply provides mailers with an expectation regarding the Postal Service's future price adjustment authority. Moreover, forecasts of what CPI-U will be in a year may not correspond to the Postal Service's actual price authority, much less to actual Postal Service prices.[399] Indeed, there are often deviations between the Postal Service's actual pricing authority when it files a notice of rate adjustment, and what mailers would have expected from forecasting changes in CPI-U under the Commission's "moving average" methodology. This is demonstrated by the chart below, which shows the differences between the Postal Service's actual price cap authority, [400] and what mailers would have anticipated if they used a well-regarded economic forecaster to predict CPI-U trends:

[399] In addition, the predictability of a system predicated on CPI-U is also dependent on the ability to accurately forecast CPI, given the economic environment (e.g., whether inflation is relatively stable). A forward guidance regime, by contrast, does not require an ability to forecast an economy-wide measure because it is based on actual rate levels.

[400] This does not take into account any "banked" pricing authority the Postal Service may have had when it filed a case.

Table 3: Comparison of actual and forecasted CPI-U and 12-month moving-average CPI-U for each month of 2016

SECTION A

CPI-U Month	Actual CPI-U	12-Month Earlier Forecasted CPI-U	Delta	Absolute Value of Delta	% Delta	Absolute Value of % Delta
Dec-16	241.432	241.978	-0.546	0.546	-0.23%	0.23%
Nov-16	241.353	242.598	-1.245	1.245	-0.52%	0.52%
Oct-16	241.729	242.097	-0.368	0.368	-0.15%	0.15%
Sep-16	241.428	242.651	-1.223	1.223	-0.51%	0.51%
Aug-16	**240.849**	**242.062**	**-1.213**	1.213	**-0.50%**	**0.50%**
Jul-16	240.628	242.084	-1.456	1.456	-0.61%	0.61%
Jun-16	241.018	242.031	-1.013	1.013	-0.42%	0.42%
May-16	240.229	241.308	-1.079	1.079	-0.45%	0.45%
Apr-16	239.261	240.344	-1.083	1.083	-0.45%	0.45%
Mar-16	238.132	239.332	-1.200	1.200	-0.50%	0.50%
Feb-16	237.111	237.463	-0.352	0.352	-0.15%	0.15%
Jan-16	236.919	236.930	-0.011	0.011	0.00%	0.00%
				Average Delta		0.899
				Average % Delta		0.37%

SECTION B

CPI-U Month	Actual 12-Month Moving Average*	12-Month-Earlier Forecasted 12-Month Moving Average*	Delta	Absolute Value of Delta	% Delta	Absolute Value of % Delta
Dec-16	1.262	1.212	0.050	0.050	3.96%	3.96%
Nov-16	1.150	1.237	-0.087	0.087	-7.57%	7.57%
Oct-16	1.051	0.970	0.081	0.081	7.71%	7.71%
Sep-16	0.928	1.142	-0.214	0.214	-23.06%	23.06%
Aug-16	**0.803**	**1.010**	**-0.207**	**0.207**	**-25.78%**	**25.78%**
Jul-16	0.723	0.986	-0.263	0.263	-36.38%	36.38%
Jun-16	0.675	1.008	-0.333	0.333	-49.33%	49.33%
May-16	0.601	0.886	-0.285	0.285	-47.42%	47.42%
Apr-16	0.513	0.322	0.191	0.191	37.23%	37.23%
Mar-16	0.402	0.010	0.392	0.392	97.51%	97.51%
Feb-16	0.325	-0.428	0.753	0.753	231.69%	231.69%
Jan-16	0.239	-0.590	0.829	0.829	346.86%	346.86%
			Average Delta			0.307
			Average % Delta			76.21%

SECTION C

Price Change	Actual Cap	12-Month-Earlier Forecasted Cap	Delta	Absolute Value of Delta	% Delta	Absolute Value of % Delta
R2017-1	0.871	1.047	-0.176	0.176	-20.21%	20.21%
R2015-4	1.966	1.662	0.304	0.304	15.46%	15.46%
R2013-10	1.696	1.054	0.642	0.642	37.85%	37.85%
R2013-1	2.570	1.881	0.689	0.689	26.81%	26.81%
R2012-3	2.133	1.010	1.123	1.123	52.65%	52.65%
				Average Delta		0.587
				Average % Delta		30.60%

* Moving average of the change in CPI-U versus 12 months prior

The table shows that forecasts of CPI-U one year in advance do not necessarily provide great assurance of what the Postal Service's actual price cap authority will be under the moving average methodology.[401] In addition, while the price cap and twelve month moving average forecasts do become more accurate as the time gap between the forecasts and the date of a price change notice narrows, a meaningful variance is

[401] Section A shows one year of actual CPI-U numbers and the forecasts for those actual CPI-U numbers that were made twelve months prior from an leading economic forecaster. For example, the December 2016 actual CPU-U number, 241.432, is compared to the number that was forecasted in the December 2015 forecast, 241.978. The two numbers are compared in both absolute and percentage terms, and then both the absolute and percentage deltas are averaged.

Section B shows actual 12-month moving averages and the re-calculation of the 12-month moving average using the forecasted CPI-U numbers, and Section C shows the actual cap numbers in the five most recent price adjustments and their forecasted numbers using the same economic forecasting company. The actual cap number will be different from the 12-month moving average whenever fewer or greater than 12-months have passed since the most recent price adjustment. The average delta decreases in Sections B and C compared to Section A, but is material, while the average percentage delta increases appreciably in Sections B and C compared to Section A, and also is material.

still possible. For example, the table below shows forecasts for the 12-month moving average for when January CPI-U was released in February 2017. It shows forecasts from 12 months before, 11 months before, 10 months before, and so on, all the way to one month before. At May 2015 (9 months before, which is the time period when the Postal Service would provide forward guidance of actual rate levels under the proposed framework), there was a significant variance between the forecasted moving average and the actual moving average.

Table 5: Comparison of actual 12-month moving-average CPI-U for January 2016, with prior forecasts

Forecast Date	Forecast of 12-Month Moving Average for Jan-16 CPI-U	12-Month Moving Average For January 2016 CPI-U	Delta	% Delta	Absolute Value of % Delta
Feb-15	-0.590	0.239	0.829	346.86%	346.86%
Mar-15	-0.526	0.239	0.765	320.08%	320.08%
Apr-15	-0.220	0.239	0.459	192.05%	192.05%
May-15	-0.052	0.239	0.291	121.76%	121.76%
Jun-15	0.130	0.239	0.109	45.61%	45.61%
Jul-15	0.320	0.239	-0.081	-33.89%	33.89%
Aug-15	0.212	0.239	0.027	11.30%	11.30%
Sep-15	0.172	0.239	0.067	28.03%	28.03%
Oct-15	0.219	0.239	0.02	8.37%	8.37%
Nov-15	0.155	0.239	0.084	35.15%	35.15%
Dec-15	0.207	0.239	0.032	13.39%	13.39%
Jan-16	0.222	0.239	0.017	7.11%	7.11%

Reliance on an *ex ante* price control is also a source of instability and unpredictability to the extent that the control is not properly specified. As the history of the current system shows, the success or failure of a price cap depends on whether its design proves to be resilient enough to accommodate changing circumstances. If a system fails to provide a regulated entity with the ability to maintain its financial stability over time, regulatory intervention is ultimately necessary to correct the design of the system. This, in turn, introduces uncertainty regarding the timing and magnitude of rate increases that are necessary to restore financial stability, uncertainty that could have been avoided if the system had given the entity the flexibility to price in a logical way from the beginning. Therefore, to the extent that the assumptions underlying the design of any revised *ex ante* price control prove to be incorrect (a topic discussed in the next section), the result would be future uncertainty, which can be avoided through a regime that is predicated on regulatory monitoring and forward guidance.

Finally, the fact that forward guidance would not be legally binding does not render this proposed approach unpredictable. "Predictability" for purposes of Objective 2 does not turn on whether a commitment is legally binding, but on whether it is credible, and hence can be relied upon by mailers when anticipating rate increases. Given that the Postal Service would under this system have the ability to use regular rate adjustments, it is unlikely that assumptions would change in the time period between the forward guidance (by class and product level) and the specific rate change notice such that the noticed rates would differ materially, if at all, from the forward guidance.[402] Indeed, as noted above, the viability of a forward guidance regime depends on the credibility of the guidance being provided, an issue that can be easily monitored by the Commission. Material deviations would likely only occur in circumstances where some significant, unexpected event has occurred between the forward guidance and the price change (an event that itself would be known to mailers); if that happens, the Postal Service would provide notice to mailers as soon as possible,

[402] As noted above, the current system creates a level of variance between the Postal Service's actual price cap authority versus what was forecasted.

and fully discuss the reasons for any deviation from its forward guidance in the price change notice.

D. Attempting to Design a More Rational Price Cap Structure Is Not Only Unnecessary, It Would Be Fraught with Risk.

Given the Postal Service's strong inherent incentives to aggressively pursue efficiency gains, only raise rates to levels that are necessary for financial stability, and give mailers predictability and stability through regular rate adjustments (which can be further ensured through a forward guidance framework), there is no basis to conclude that maintaining an *ex ante* price control is necessary to achieve the objectives. In addition, attempting to design an alternative price cap structure would not only be unnecessary to achieve the objectives, but it would also be a complex exercise that is fraught with risk.

First, as discussed by Christensen Associates in Appendix E, any revised price cap system would have to include a number of design elements if it is to correct the profound deficiencies of the current CPI cap, and provide a framework that is at least theoretically capable of achieving the objectives.[403] Several of the elements discussed by Christensen reflect certain fundamental considerations that are not appropriately taken into account by the current cap, such as the need for any price cap to (1) directly reflect the Postal Service's expected unit cost trends, as dictated both by those factors that inflate Postal Service costs (e.g., labor cost growth, the cost of fuel, and so on), as well as by its declining economies of density (which increases unit costs even without

[403] Appendix E at 31-35.

bringing cost inflation into the equation); and (2) to account for exogenous cost changes that are outside of the Postal Service's control.[404]

Other elements discussed by Christensen, particularly regarding the need to include an automatic stabilizer and re-opener provisions as backstops,[405] are predicated on the fundamental fact that the postal marketplace is both inherently uncertain and extremely challenging for the Postal Service, for the reasons discussed above. For instance, future volumes of market-dominant products are subject to a large number of non-price factors that are ultimately outside of the Postal Service's control, including future economic conditions and future trends in electronic diversion. Given these factors, as well as the Postal Service's current precarious financial position, the Postal Service's ability to maintain financial stability, and hence achieve the various other objectives that are dependent on financial stability, would be extremely sensitive to the assumptions used by the Commission in designing an alternative cap.

As discussed above in Section V and in Appendices D and F, these considerations have led to the abandonment of price caps in the postal sectors of other countries. In particular, Postcomm in the UK attempted to create a price cap that could address Royal Mail's circumstances, which resulted in an extremely complex price cap structure that ultimately failed to provide Royal Mail with the ability to maintain its financial stability. When Ofcom took over postal regulation, it quickly jettisoned the Postcomm cap, concluding that the continuation of an ex ante price control was fundamentally unnecessary in the postal sector, and that it should instead give Royal

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404 *Id.*

405 *Id.*

Mail commercial freedom in order to ensure the continued provision of financially sustainable universal service.[406] In addition to concluding that Royal Mail had inherent incentives to be efficient and not raise rates to excessive levels, Ofcom noted that "[a] price control is unlikely to be effective in the current context, given the level of uncertainty within the postal market, and the very high sensitivity of Royal Mail's profitability to changes in the assumptions used in setting a price control[.]"[407]

In 2012, Ofcom determined that, given Royal Mail's financial condition and the challenges presented by declining mail volumes, the use of an *ex ante* price control was not an appropriate means of ensuring that Royal Mail was efficient, financially stable, and capable of providing high-quality service. Instead of subjecting Royal Mail to an *ex ante* price control, Ofcom determined that monitoring Royal Mail's financial condition, operational efficiency, and service performance "would be the most effective mechanism" to ensure that Royal Mail is sustainably providing universal service in an efficient manner.[408]

To assess Royal Mail's financial stability and protect against the setting of excessive rates, Ofcom monitors a number of financial metrics, the most prominent being whether Royal Mail is operating consistently within an EBIT margin range of 5-10

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[406] Appendix F at 8.

[407] Ofcom March 2012 Decision at ¶ 6.7. *See also id.* at ¶ 6.40 (noting that "in recent years, [Royal Mail] has incurred losses on the universal service network, and its plan indicates that it may not achieve cash flows consistent with the returns we determined were appropriate…for some time. We cannot therefore safely assume that the same approach as we use in other sectors will be appropriate for regulating Royal Mail.").

[408] *Id.* at ¶ 6.7 ("A monitoring regime would be the most effective mechanism for ensuring that Royal Mail did not seek to return to profitability through price rises alone, i.e. without also improving efficiency."); *see also* Appendix F at 9-10. Ofcom also imposed a "safeguard cap" on Second-Class letters, flats, and small parcels. This is discussed below.

percent.[409] Ofcom also monitors "the underlying factors contributing to Royal Mail's earnings, and whether these are largely underpinned by improved operational performance and efficiency gains, or whether they are more generally driven by price rises," in order to ensure that Royal Mail is pursuing efficiency gains.[410] Ofcom monitors efficiency through considering a variety of information, rather than by imposing any specific efficiency targets on Royal Mail.[411] Finally, Ofcom monitors the Royal Mail's service performance by measuring whether Royal Mail has achieved certain performance targets.[412]

As discussed in section VI.B.1 above and in Appendix F, Ofcom recently reviewed whether its regulatory monitoring approach remains appropriate in light of the fact that (1) the only end-to-end competitor to Royal Mail, Whistl, has left the market; (2) Royal Mail has used its commercial flexibility to improve its financial position; and (3) there has been "[a]n intensification in the level of competition and innovation in parcel services."[413] Ofcom determined to retain its monitoring approach through 2022 (while retaining the right to intervene sooner if necessary),[414] reaffirming its conclusion in 2012 "that commercial flexibility, subject to certain safeguards, along with the

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[409] Appendix F at 9. As Ofcom has noted, this range is not a cap on earnings, and nor is it a guarantee. *Id.* at ¶ 5.42.

[410] Ofcom March 2012 Decision at ¶ 5.47.

[411] Ofcom, March 2017 Review Decision ¶¶ 3.3, 3.170-3.171.

[412] *See id*. at ¶¶ 3.24-3.30.

[413] *Id.* at ¶ 1.4.

[414] *Id.* at ¶ 1.21 (noting that it could intervene sooner if "the financial sustainability of the universal postal service" was threatened in a manner "which Royal Mail could not deal with through commercial action alone"; if Royal Mail was acting in a manner that produced "[n]egative outcomes for consumers, such as significant price increases or poor quality of service"; or if there was "[f]ailure on Royal Mail's part to make sufficient progress on improving its efficiency, exposing consumers to higher prices and/or a lower quality of service than might be the case in a competitive market.").

achievement of a reasonable rate of efficiency improvement, is the most likely means by which Royal Mail will be able to secure the financial sustainability of the universal postal service despite the challenges it faces."[415] In particular, Ofcom noted that:

- The monitoring regime "has been largely positive for consumers—both residential and business customers."[416] Consumer satisfaction "remains high," and there has been "general improvement" in Royal Mail's service performance since the monitoring regime was put in place.[417]
- Royal Mail is not pricing at excessive levels: while it raised rates substantially in order to restore profitability, thereafter it has been pricing at a restrained level.
- Royal Mail is operating at the low end of 5-10 percent EBIT range, and that while "the universal service is likely to remain financially sustainable in the immediate future…downside risks remain in the forecasts," including the "structural decline" in letters, economic uncertainty, "cost challenges" facing Royal Mail (regarding issues such as its pension costs), and "the competitive pressures on Royal Mail's parcel volumes and revenues."[418]
- Although the rate of efficiency growth had declined in the most recent year, overall Royal Mail was demonstrating a reasonable rate of efficiency improvement, demonstrating that "the regulatory framework and market conditions appropriately incentivise Royal Mail to pursue efficiency improvements

[415] *Id.* at ¶ 1.19.

[416] *Id.* at ¶ 3.31.

[417] *Id.* at ¶¶ 3.24, 3.31.

[418] *Id.* at ¶¶ 3.66, 3.172.

rather than excessively raising prices."[419] Ofcom therefore again rejected arguments that it should impose efficiency targets, noting that the monitoring regime was appropriate for that purpose.[420]

Ofcom also reiterated its view, underlying its original 2012 order as well, that the uncertainty of the postal marketplace presented significant risk in attempting to design an *ex ante* price control:

> Finally, as we explained in 2012 when we established the regulatory framework, there are a number of risks inherent to introducing a price control in highly uncertain market environments. More specifically, where the level and pattern of demand is unclear, it is not feasible to predict accurately whether a given price trajectory would be adequate to ensure the provision of the universal service is financially sustainable. For all of these reasons, we do not consider that the imposition of price controls or efficiency targets is justified at this time.[421]

The same considerations apply to the Postal Service. The Commission could theoretically attempt to design a price cap system to enable the achievement of the objectives; such a system would need to reflect the complexities of the Postal Service's cost structure and be resilient enough to handle changing circumstances. However, such an effort is not only unnecessary but also fraught with risk, given the uncertainty of future mail volumes and the precariousness of the Postal Service's financial situation. Rather than going down a path similar to the rejected Postcomm approach, the

[419] *Id.* at ¶¶ 3.98, 3.99. Ofcom also expressed the view that "Royal Mail has the potential to make greater efficiency gains than those it is currently forecasting and those contained in the 2015 Business Plan." *Id.* at ¶ 3.101.

[420] *Id.* at ¶ 3.175 ("We have a well-established monitoring regime which provides us with sufficient information to make an informed judgement as to whether the regulatory framework continues to incentivise Royal Mail to pursue efficiency improvement. In these circumstances, we do not consider that an efficiency target is necessary for us to make a judgement about its efficiency performance. We will continue to monitor Royal Mail's efficiency performance closely and publish our analysis of its efficiency in our annual monitoring update on the postal market.").

[421] *Id.* at ¶ 3.176.

Commission should instead adopt a much more straightforward regulatory monitoring regime, supplemented by forward guidance. The durability and success of Ofcom's approach amid a changing and challenging postal marketplace speaks for itself: Royal Mail has been able to both achieve reasonable benchmarks of financial stability and improve service performance, while improving efficiency and not seeking to raise rates in an excessive manner. Ofcom's approach has succeeded where Postcomm's attempt to design a suitable *ex ante* price control for the postal sector failed.

The experience in Canada bolsters the Ofcom model. Like the Postal Service, Canada Post is a government-operated monopoly and was subject to a rigid CPI-based price cap for ten years (from 1999 to 2009). However, the Government abandoned the cap because it was not allowing Canada Post the ability to achieve financial stability and sustain the universal service as volumes declined.[422] Although Canada retains an *ex ante* regulatory model, it appears to be based on substantial deference to Canada Post's revenue needs, with no reference to CPI, and with the Government monitoring efficiency qualitatively.[423]

The experiences in France and Germany further demonstrate the unnecessary complexities of attempting to create a rational price cap structure. Both cap formulas attempt to forecast volume and cost trends for their respective posts. In both instances, the cap formulas as designed did not prove adequate to ensure that the respective

[422] Appendix F at 16-18.

[423] *Id.* at 18. Australia is another country where the postal regulator affords the postal operator substantial leeway to set prices without reference to a price cap, while monitoring efficiency and service quality. *Id.* at 20-23. Like Ofcom, the Australian regulator's recent opinions are consistent with the conclusion that volume declines provide inherent incentives for the postal operator to increase efficiency and to moderate price increases. *Id.* at 23.

posts could respond appropriately to volume declines, necessitating intervention in order to adjust the formulas. In France, the postal regulator had to reopen the price cap ahead of schedule and significantly revise it when volume forecasts proved overly optimistic.[424] In Germany, Deutsche Post was in a better financial position than most because its rates were already at a relatively high level and volume declines were occurring more gradually than in other countries. Nevertheless, the challenges facing the postal sector – volume declines from electronic substitution, fixed delivery costs, lost economies of scale and delivery density, diminished productivity, and rising unit costs – impelled the Government to legislate a change to the price cap formula that yielded a true-up of regulated letter prices.[425] Both the French and German examples demonstrate the risk of error in setting the assumptions that would underlie any revised price cap system, and the prospect that such error necessitates a level of regulatory intervention to alter the design a price cap formula (and the regulatory proceedings that would go along with such alterations) that would be unnecessary in a flexible structure of regulatory monitoring. Given the fundamental lack of need to pursue such an approach, the Commission should pursue a simpler approach to achieving the objectives.

E. A Monitoring Regime Is Well-Suited to Achieving the Objectives.

The current statutory structure is well-suited to allowing the Commission to administer a robust and transparent monitoring regime in order to ensure that the objectives are being achieved. The Postal Service is already required by the statute

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[424] *Id.* at 27-30.

[425] *Id.* at 34-37.

and Commission regulations to report a broad array of information regarding its financial condition, costs, operating efficiency, and service performance.[426] The Commission, furthermore, has the statutory authority to require the Postal Service to provide additional information as it deems necessary to construct a robust monitoring regime.[427] This transparency, coupled with the Postal Service's inherent incentives as discussed above, provide the Commission with ample ability to ensure that the Postal Service is acting appropriately. Statutory processes also exist through which the Commission can step in and order remedial action to the extent that its monitoring identifies problems.[428] Finally, as an ultimate backstop, the statute authorizes the Commission to set forth an alternative regulatory framework it if considers that a regulatory monitoring approach is not achieving the objectives;[429] the prospect of having an revised regime would help to further ensure that the Postal Service is adhering to the objectives.[430]

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[426] 39 USC U.S.C. §§ 3652, 3654; 39 C.F.R. Part 3050.

[427] 39 U.S.C. §§ 3652(e), 3654(e).

[428] *Id.* §§ 3653, 3662. The fact that Section 3681 bars refunds for rates that are subsequently deemed unlawful is certainly no reason to maintain an *ex ante* price control. There is no rational basis to assert that this provision would give the Postal Service any incentive to price in a legally dubious manner, simply because it would not have to return revenue generated from rates subsequently held to be unlawful. Indeed, the Commission would always have the authority to fashion a prospective remedy to remedy any unlawful action by the Postal Service, which could include reduced pricing authority and the imposition of more burdensome regulation. As such, any effort by the Postal Service to take advantage of Section 3681 would constitute only a short-term gain, which the Postal Service would know would be far outweighed by the longer-term repercussions.

[429] *Id.* § 3622(d)(3).

[430] The Commission should impose a set period of time following which it will conduct a comprehensive review of the regulatory monitoring regime, consistent with the fact that the Commission is now empowered to review the regulatory system "as appropriate."). *Id.* At the same time, principles of regulatory certainty dictate that the Commission should not conduct this review until a meaningful period of time has elapsed (5 years would be reasonable), and should only examine the system in advance of that time if significant, unanticipated circumstances occur. *Cf.* Ofcom March 2017 Review Decision at ¶ 1.21 (offering possible grounds for reexamination of the regulatory monitoring approach before 2022). In this regard, Ofcom's recent reexamination of the system was prompted in large part by Whistl's departure from the end-to-end letter delivery market, a marketplace development that undercut Ofcom's view in 2012 that the prospect of end-to-end competition also justified a regulatory monitoring approach.

Through such a structure, the Commission would continue to monitor the Postal Service's costs, financial condition, efforts to improve efficiency and reduce costs, and service performance. Regarding the first issue, Evercore provides suggested financial metrics that the Commission can use to monitor the Postal Service's financial position, regarding profitability, leverage, and liquidity.[431] For instance, Evercore proposes that the Commission assess the Postal Service's ability to sustainably cover its costs through the use of EBT margins, and proposes an indicative range that could be used to monitor that issue moving forward. The Commission can monitor these and any other financial metrics it considers relevant (and periodically assess the appropriateness of the ranges its sets) to ensure that the Postal Service is exercising its pricing flexibility in accordance with the objectives, in that it is pursuing financial stability but is not seeking to price in an excessive manner.

Furthermore, the Commission would also comprehensively monitor the Postal Service' operational performance, to ensure that the Postal Service is keeping a sharp focus on maintaining operational efficiency and reducing costs. This can be done through metrics such as TFP, as well as by assessing the Postal Service's cost reduction initiatives and future operational plans. However, the Commission should not set any explicit efficiency targets: ultimately, the setting of accurate targets would be extremely difficult, and could therefore force the Postal Service to make sub-optimal management decisions in a given year simply to ensure that the targets are achieved. Indeed, as Christensen notes, it is not possible to use prior TFP results as a basis to

[431] Appendix B at 35-37.

predict what the Postal Service should be able to achieve in the future, and TFP can appropriately vary from year to year:

> While TFP is a comprehensive measure of operational efficiency, TFP does not determine the sources of productivity improvements, nor does it indicate what TFP increases are achievable. TFP is a “top-down” measure of operational efficiency; it does not provide a “benchmark” that specifies the degree to which TFP can increase if best practices are adopted. Furthermore, TFP in most industries has substantial year-to-year variations due to business cycles, the pattern of investment in new technologies, and strategic changes in business plans. When using TFP as an evaluation tool of management, it is important to look at TFP trends over several years rather than isolated annual TFP results.[432]

Giving the Postal Service the flexibility to set prices at levels deemed necessary to maintain financial stability, while monitoring the Postal Service’s service performance, would also ensure high-quality service performance, and hence achieve Objective 3. As an initial matter, the Postal Service has inherent incentives to set service standards at the appropriate levels and to provide high-quality service within those standards. For instance, poor service performance can make the use of the mail less attractive, and hence can hurt the Postal Service financially; poor service performance also attracts negative public and political attention.[433] Furthermore, the current processes by which service performance is measured, reported, and monitored through Sections 3652 and

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[432] Appendix D at 1. *See also id.* at 6 (“Because TFP by itself does not show what productivity gains are achievable, it is not possible to conclude that the TFP increase in any one year is essentially ‘good’ or ‘bad’ without further information on what productivity gains are achievable, whether a firm is strategically sacrificing short-run productivity gains to achieve longer-run productivity gains, or whether unexpected changes in business conditions have led to a slowdown in TFP growth. It is more useful to evaluate TFP performance over several years instead of on a year-by-year basis for the reasons listed above.”).

[433] As additional incentive for service performance comes from the Postal Service’s National Performance Assessment program, which weights service performance most heavily.

3653 have been successful at providing transparency, and therefore helping to ensuring that issues are identified and corrective action is taken by the Postal Service.[434]

Therefore, the critical issue is to ensure that the market-dominant regulatory system helps to prevent service problems from arising in the first place, by giving the Postal Service the capability to maintain financial stability, rather than being in a position of perpetual financial distress that inhibits capital investments and forces the Postal Service to undertake operational initiatives at a pace that sometimes proves counter-productive to maintaining service. As such, there is no need for the Commission to adopt additional regulations at this time regarding service performance.[435] Rather, the Commission should enable the Postal Service to achieve and maintain financial stability, and monitor the Postal Service's service performance moving forward.[436]

Predictability and stability are both policies that are easily enforced through a regulatory monitoring regime, supplemented with the forward guidance framework

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[434] *See, e.g.*, Postal Regulatory Comm'n, Annual Report to the President and Congress, FY2012, at 23 ("The Annual Compliance Determination (ACD) provides reliable insight into the Postal Service's quality of service obligation."). *See also* Letter from Robert Taub, Acting Chairman, Postal Regulatory Comm'n, to Lori Rectanus, General Accountability Office, Regarding GAO Report No. 15-756 (Sept. 11, 2015), at 2-6 (noting the robustness of the current system of service performance reporting).

[435] In particular, it would be wholly irrational to seek to reduce the Postal Service's ability to use price as a tool to address its financial stability because of service level changes or service performance trends. Ultimately, if any post is to survive in the current and future marketplace, it must adapt to the declining demand for the mail by appropriately balancing its costs (derived in significant part by service levels) with its rate levels. This requires giving the post the commercial flexibility to adopt a comprehensive approach. The current system has failed precisely because it did not provide the Postal Service with the requisite flexibility over one significant lever: price. Moreover, penalizing service performance issues by denying a post necessary pricing authority is, for the reasons discussed above, counter-productive to improving service. Moreover, the complexity of administering a service-quality adjustment factor would likely outweigh any (attenuated) incentive effects. Ofcom abolished Postcomm's adjustment factor for precisely that reason, and the French regulator likewise declined to adopt one. Appendix F at 6-7, 9 fn.30, 25.

[436] As discussed in section V.B.2 above and Appendix F, the surveyed postal regulators tend to review service performance in qualitative terms. The threat of regulatory intervention is deemed to serve as an adequate incentive for the postal operator to maintain high-quality service.

proposed above. As the Commission notes, "stability" is simply a concept that contemplates how rates change over time, and hence can easily be monitored by the Commission on an ongoing basis. Regarding predictability, the Commission can monitor the extent to which the Postal Service's forward guidance is providing mailers with predictability.

In addition, the Commission would continue to dictate the Postal Service's costing methodologies and assess its compliance with Section 3633 through competitive product filings and the ACD, and thereby ensure that Objective 9 is being met. In this regard, there is no need to retain a price cap in order to ensure that the Postal Service fulfills its obligations regarding competitive products. Under a regulatory monitoring approach, the Commission would continue to monitor whether competitive products are covering their incremental costs, as determined under Commission methodologies, and therefore ensure that the Postal Service's flexibility to set higher rate levels for market-dominant products is not enabling cross-subsidization of the competitive side. As such, the Commission should reject any arguments that a price cap is needed to protect fair competition on the competitive side, or to protect market-dominant customers from subsidizing competitive products. Indeed, the Postal Service has demonstrated that it has strong incentives to pursue significant contribution from the competitive side, in order to support its overall financial viability; this serves to reduce the need to raise rates on market-dominant mailers.

Finally, a monitoring approach would also enable the Commission to ensure the achievement of the other objectives. First, the Commission would continue to monitor the specific prices set by the Postal Service to ensure that the Postal Service is fulfilling its legal obligations, regarding matters such as workshare discounts, minimum rates, and the provisions of Section 3626. Second, a regulatory monitoring approach would both reduce the administrative burden of the regulatory process and enhance its transparency. Third, by giving the Postal Service the capability to restore financial stability, a regulatory monitoring system would ensure that the Postal Service has the resources needed to secure the mail.

F. There Is No Need for a Safeguard Cap to Be Imposed on Single-Piece First-Class Mail in Order to Achieve the Objectives.

While rejecting a comprehensive *ex ante* price control in favor of a regulatory monitoring regime, Ofcom did impose "safeguard" caps on "Second Class" single-piece letters, large letters, and small parcels, in order to provide an affordability backstop for the universal service products most used by individuals and small businesses.[437] Ofcom noted that "Second Class" is appropriate to subject to safeguard caps because "[v]ulnerable customers were more likely to use this service," with "vulnerable" defined as the disabled, the elderly, and those with low incomes.[438] However, for the reasons discussed above, there is no need for a similar safeguard to be imposed on Single-Piece First-Class Mail, which is the closest equivalent to Second Class mail in the UK.

Initially, it is critical to emphasize that a "safeguard cap" is <u>not</u> a price cap, and its imposition did not derogate from Ofcom's conclusion that commercial flexibility for Royal Mail coupled with monitoring, rather than an *ex ante* price control, was appropriate. As noted above, a price cap is set to reflect the expected cost trends of the regulated entity, and it seeks to incent efficiency by motivating the entity to reduce costs below

[437] Appendix F at 10-12.

[438] Ofcom March 2012 Decision at ¶¶ 1.36, 8.141.

that assumed by the price cap, and hence to capture profits that it can generate from raising rates up to the cap. By contrast, Ofcom has emphasized that the purpose of the safeguards caps is to ensure affordability, and has analyzed their appropriateness from that perspective. Indeed, it has specifically rejected comparisons between a price cap and the safeguard caps:

> First, it is not appropriate to compare Royal Mail's decision to price under the caps for Second Class stamp letters and large letters with the price caps for other regulated companies in the UK. The safeguard cap on Second Class letters is not based on Royal Mail's costs. It also gave Royal Mail the freedom to increase prices by 53% in the first year in which the cap was in place (increasing by CPI in further years). Many of the price controls Royal Mail cited are based on the costs of the incumbent, including an adjustment to future costs to reflect expected efficiency improvements, and are likely to have limited the pricing flexibility of the relevant companies to a much greater extent than the Second Class safeguard cap has limited Royal Mail's pricing freedom. [439]

As indicated in this passage, Ofcom set the safeguard cap substantially above the rates in effect at the time: the caps were initially set at levels that were 53 percent above 2011-2012 rates for the relevant products, and would thereafter rise at CPI for a seven year period (when they will be re-examined). This level was not based on a consideration of Royal Mail costs, but on whether increases of this magnitude would still ensure that Second Class Mail rates are affordable for vulnerable customers, while also allowing Royal Mail the necessary commercial flexibility. In addition, Ofcom noted that the safeguard caps were not designed to supply efficiency incentives (rather, as noted above, it has concluded that Royal Mail has inherent efficiency incentives).[440]

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[439] Ofcom March 2017 Review Decision at ¶ 3.115.

[440] Ofcom, Securing the Universal Postal Service: Safeguard Cap for Large Letters and Parcels (July 20, 2012) [hereinafter "Ofcom July 2012 Decision"], at ¶ 3.54, https://www.ofcom.org.uk/__data/assets/pdf_file/0015/72042/statement.pdf (rejecting stakeholder concern that safeguard cap was set at a level that would not supply "efficiency incentives" by noting that

Therefore, rather than serving as a price cap, the safeguard caps were designed to provide a backstop, placed substantially above existing rates, to protect the affordability of a basic universal service for vulnerable customers, while at the same time not constraining Royal Mail's commercial flexibility to ensure a financially sustainable universal service. Ofcom noted that the caps were designed so as to protect affordability while "[minimizing] the impact of the cap on Royal Mail's pricing flexibility," in order to ensure that the caps would not "compromise the wider financeability and efficiency incentives we consider will be created by not imposing a traditional price control."[441] Therefore, in setting the scope of the safeguard caps, Ofcom has analyzed whether they would "materially constrain Royal Mail's pricing for other products," considering the differentials between those products and the products subject to the safeguard caps.[442] It also rejected proposals to expand the scope of the cap to other products that Ofcom considered would unduly hinder Royal Mail's flexibility by bringing too much revenue under the cap.[443] Finally, it rejected proposals to lower

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the "main justification for putting the safeguard cap in place is to ensure that a basic universal service product is available to all," and that "Royal Mail has inherent efficiency incentives in any event"); Ofcom March 2012 Decision at ¶¶ 8.93-8.94 (noting that "the safeguard cap is not intended, in and of itself, solely to provide efficiency incentives to Royal Mail," and is "also not intended to impose a significant constraint on Royal Mail's pricing flexibility," but rather its "key objective is to ensure that a basic affordable universal service product is available to all and in particular vulnerable consumers."). *See also* Ofcom March 2017 Review Decision at ¶¶ 3.178, 4.44 (retaining safeguard caps as "an affordability measure, in order to ensure that consumers, in particular, vulnerable consumers, continue to have access to a universal service at affordable prices.").

[441] Ofcom March 2012 Decision at ¶ 8.143. *See also id.* at ¶ 8.63 (stressing that it designed the safeguard cap on letters in order to "[minimize] the effect of the safeguard cap on Royal Mail's pricing freedom so as to avoid a material effect on wider financeability and/or efficiency incentives").

[442] Ofcom July 2012 Decision at ¶ 3.13. *See also* Ofcom, Review of the Regulation of Royal Mail (May 25, 2016), at ¶ 5.16, https://www.ofcom.org.uk/__data/assets/pdf_file/0028/78184/review-of-royal-mail-regulation.pdf; Ofcom March 2012 Decision at ¶ 8.136.

[443] Ofcom July 2012 Decision at ¶ 2.42 (noting that "a cap on First Class stamps or both First and Second Class stamps would be likely to directly and indirectly constrain a significant proportion of Royal Mail's

the initial level of the caps from below the 53 percent level on the basis that there was no evidence that the level it chose presented affordability concerns.[444]

In fact, while Royal Mail substantially increased rates in order to restore financial stability, those increases fell well below the safeguard cap level; in addition, Royal Mail has never sought to increase rates since then to the full extent allowed. Ofcom has cited to the fact that Royal Mail has never priced up to the safeguard caps as a factor that justifies their retention, since that has meant that the caps "did not appear to unduly constrain [Royal Mail's] pricing flexibility."[445]

There is no reason for the Commission to conclude that a similar type of affordability backstop is necessary for purposes of Single-Piece First Class Mail. First, there is no basis to conclude that users of this product need any sort of special protection that would not be amply provided through a monitoring regime. In particular, the first-ounce First-Class Mail letter rate is the most high-profile rate set by the Postal

revenues and that this did not meet our objective of minimising the effect of the safeguard cap on Royal Mail's pricing freedom.").

[444] Ofcom March 2012 Decision at ¶¶ 8.95, 8.107 (noting that "there has been no evidence provided which indicates that the proposed range of levels for the safeguard cap are unaffordable for vulnerable consumers," and that "given that it does not appear to show that 55p for Second Class stamps is close to the level of affordable postal prices for vulnerable consumers and that this price for Second Class stamps would not be out of step with other European countries, we consider it is appropriate to give more weight to allowing Royal Mail greater commercial flexibility"). To assess affordability, Ofcom considered the levels of spending on the Second Class products, noting that "postal expenditure remains a very small proportion of total household outgoings." *Id.* at ¶ 8.69. This was also the case for low-income households, which send less mail than higher-income households. *Id.* at ¶ 8.79. Overall, Ofcom concluded that raising the Second Class Letter rate to 55 pence did not raise affordability concerns because it would on average raise total postal expenditure by a minimal amount on average. *Id.* at ¶ 8.81. In this regard, as discussed in Section V and Appendix F, Ofcom's decision aligns with decisions made in other countries like Canada and Australia, which also noted that significant price rises did not present affordability concerns based on low household spending on postal services.

[445] Ofcom March 2017 Review Decision at ¶¶ 4.32, 4.46.

Service, and there is no reason why the Postal Service would seek to discriminate against such customers.

Moreover, affordability concerns for vulnerable customers are minimal when it comes to Single-Piece First Class Mail. As noted in Appendix B, the Postal Service's first-ounce letter rate is very low compared to other posts on a Purchasing Power Parity basis.[446] Even an extremely significant increase would not result in a rate that could be considered to be unaffordable from an international perspective. Moreover, the volume of First-Class Mail sent by households generally, and low-income households in particular, are also very low: the FY2015 Household Diary Study estimates that households send 64 pieces of mail annually (or 1.2 pieces per week), while the lowest-income households with relatively low internet access only send 0.7 pieces of mail per week.[447] Thus, even a substantial increase would mean only a small amount of additional expense for vulnerable customers.

Therefore, the imposition of a safeguard cap predicated on affordability concerns would be a substantively unnecessary exercise. Rather, considering existing Postal Service rate levels, and the low levels of postal expenditure by low-income households, regulatory monitoring can fully protect affordability. Nevertheless, if the Commission sought to create one or more safeguard caps in conjunction with a regulatory monitoring regime, it would have to be careful to ensure that simply serves as an affordability backstop, and does not turn into a *de facto* price cap.

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[446] Appendix B at 16.

[447] FY2015 Household Diary Study at 8, 13. Household mail use is therefore "strongly correlated with both income and education." *Id.* at 12.

G. The Commission Should Not Fully Impose Efficient Component Pricing as a Binding Restraint on Workshare Discounts.

The Postal Service anticipates that some parties will urge the Commission to establish rules that would mandate the full application of ECP, so that the Postal Service is legally restricted from setting discounts below as well as above avoided costs, unless certain exceptions are met. For two reasons, the Commission should reject any such arguments.

First, the statute does not empower the Commission to alter the standards governing workshare discounts to fully impose ECP. Various parties have previously urged the Commission to set binding limits on discounts below avoided costs.[448] However, the Commission has appropriately declined to do so, based on a recognition that Congress, through the highly detailed language of Section 3622(e), determined only to restrict the Postal Service's pricing flexibility regarding workshare discounts by partially imposing ECP, and that it is improper for the Commission to impose additional standards on those discounts beyond those set forth by Congress:

> The Efficient Component Pricing (ECP) rule holds that if a workshare discount exceeds the cost avoided by worksharing, it will encourage a less efficient producer (the private mailer) to do the work. There is a consensus among the commenters that the Congressional purpose in limiting workshare discounts at the level of avoided costs is to have workshare discounts comply with this element of the ECP rule. If the discount is less than the cost avoided by worksharing, it will likewise encourage a less efficient producer (in this case, the Postal Service) to do the work. Some commenters ask the Commission to apply both elements of the ECP rule when evaluating workshare discounts. NPPC Reply Comments at 9; PostCom Reply Comments 8-10. The Commission finds that of these two aspects of the ECP rule, only the former is reflected in section 3622(e). While the Commission considers ECP an economically beneficial pricing practice, Congress acted to prevent workshare discounts

[448] *See, e.g.*, Comments of Pitney Bowes, Inc., PRC Docket No. PI2016-3 (June 14, 2016), at 3-17.

> that are too large, but did not include language specifically to prevent discounts that do not pass through the full measure of costs avoided.[449]

Nothing in Section 3622(d)(3) justifies a change in approach. As noted above in Section II, the standards governing workshare discounts set forth in Section 3622(e) are not properly within the scope of this review. Given that fact, there is no basis for the Commission to conclude that it now has authority to impose additional restrictions on workshare discounts that it has heretofore lacked.

Second, even if the Commission were to have the authority to mandate that workshare discounts fully conform to ECP, it still should not impose such a requirement, because it would not constitute an appropriate means of balancing the various objectives. While ECP may advance the achievement of Objective 1 in some respects (as well as take into account Factor 5), that objective must still be balanced against other objectives whose achievement would be significantly undermined by the full application of ECP, particularly the objective that the system accord the Postal Service "pricing flexibility." Application of ECP as both a floor and ceiling for workshare discounts could also work against Objective 2 by effectively requiring that any changes in measured cost avoidances be transmitted into changes in rates.

In particular, while the Postal Service recognizes that the Commission has repeatedly expressed its belief in the importance of following ECP as a principle of

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[449] Order No. 536 at 37-38. *See also* Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2015 (Mar. 28, 2016), at 10 (noting that "passthroughs below 100 percent are lawful"); Order No. 1320, Order Resolving Technical Issues Concerning the Calculation of Workshare Discounts, PRC Docket No. RM2010-13 (Apr. 20, 2012), at 3 fn.2 ("The most notable departure in section 3622(e) from the approach taken by the former Postal Rate Commission is that it places only a cap on the size of the discount. Under section 3622(e), the Postal Service may offer as small a discount for worksharing as it sees fit."). Rather than imposing a binding restraint, the Commission has only set forth a rule that requires the Postal Service to "to identify and explain" any discounts "substantially below avoided costs." 39 C.F.R. § 3010.12(b)(6).

pricing,[450] the Commission has also recognized that a fundamental purpose of the PAEA, as reflected in the objectives, was to give the Postal Service pricing flexibility.[451] Whereas under the PRA rate design was generally within the purview of the Commission, the PAEA authorizes the Postal Service to balance the various principles set forth in the statute that are applicable to the setting of rates, with the Commission's role to ensure only that the Postal Service's exercise of that discretion does not violate any legal standards.[452] In this regard, Objective 1 and Factor 5 are not the sole considerations that must be balanced when it comes to making pricing decisions, and the statute authorizes the Postal Service to consider a wide variety of competing issues in doing so.[453]

Moreover, while the Postal Service believes that consideration of ECP is a useful principle when it comes to setting workshare discounts, ECP is known in the economics literature to constitute an optimal regulatory policy only under highly restrictive conditions on postal costs, demands, and market structure.[454] ECP focuses primarily on productive efficiency in the workshared activities, not allocative efficiency issues related to the markups for various products, such that optimal workshare prices

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[450] *See, e.g.*, Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2015, at 10 (March 28, 2016) ("Although passthroughs below 100 percent are lawful, they send inefficient pricing signals to mailers. Passthroughs set as close as possible to 100 percent would promote efficiency, lower the total combined costs for mailers, and encourage the retention and growth of the Postal Service's most profitable products."); Order No. 596 at 20-21 & n.12; Order No. 26 at 23.

[451] *See, e.g.*, Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2012, at 22 ("Title 39 gives the Postal Service pricing flexibility for market dominant products. That pricing flexibility is guided by nine objectives and 14 factors and is not limited to a cost-based or demand-based approach. In exercising its pricing flexibility, the Postal Service must engage in a balancing process.").

[452] *Id.*

[453] *Id.*

[454] *See, e.g.*, Jean-Jacques Laffont & Jean Tirole, *Access Pricing and Competition*, 38 EURO. ECON. REV. 1673-1710 (Dec, 1994).

generally will differ from ECP. There is inadequate economic justification for making ECP cost avoidances the sole basis for worksharing discounts.

Workshare discounts form a substantial and critically important part of the Postal Service's rate schedule. Requiring that the Postal Service adhere to a single theoretical economic model, like the ECP rule, when it comes to making decisions regarding its workshare discounts would therefore largely vitiate the Postal Service's pricing flexibility. Given this fact, as well as the fact that no argument can be made that the achievement of Objective 1 mandates the full application of ECP (that is, productive efficiency considerations emphasized by ECP do not solely ensure that pricing efficiency is achieved, and in any event the Objective can be appropriately effectuated through a regulatory regime that does not fully mandate ECP), the Commission should not find that setting binding restrictions on discounts below avoided costs is an appropriate balancing of the objectives, taking into account the factors.[455]

In balancing the relevant statutory considerations regarding the setting of rates, the Postal Service is fully cognizant of the importance of workshare discounts to keeping the mail an attractive means of communication for bulk mailers, and has demonstrated that it is sensitive to the need to ensure that workshare discounts send efficient price signals.[456] However, in exercising the pricing flexibility granted by the PAEA, the Postal Service can legitimately determine that setting particular workshare discounts below 100 percent of avoided costs is appropriate.

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[455] Certainly, Factor 5, which simply states that "the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service" should be "taken into account," does not justify such a significant reduction in the Postal Service's pricing flexibility.

[456] *See, e.g.*, United States Postal Service Notice of Market-Dominant Price Adjustment, PRC Docket No. R2017-1 (Oct. 12, 2016), at 19-21.

To be revenue-neutral, increasing discounts that are generally below 100 percent of avoided costs to 100 percent would necessarily involve price reductions for some rate cells and increases for others. Such a change would tend to shift responsibility for covering the costs of the Postal Service from mailers using more highly workshared products to mailers using less-workshared products, but the welfare consequences of the change are ambiguous. Of course, increasing the discounts without raising prices for benchmark products could negatively affect the Postal Service's overall financial position (in contravention of Objective 5). Objective 5 may also be adversely affected to the extent the Postal Service cannot fully capture the estimated cost avoidances.

As a practical matter, cost avoidances for workshared products are estimated on a backward-looking basis, as part of the Annual Compliance Report, after postal prices including workshare discounts have been set. It is inevitable that discounts set at 100 percent of anticipated cost avoidances will differ from the actual *ex post* measurements produced for the ACR. The measured cost avoidances are subject to sampling variability from cost systems, as well as effects from changes in Postal Service operations and technology. However, under a strict implementation of ECP, unpredictable changes in avoided costs would seem to be required to be translated into unpredictable changes in discounts, possibly working at cross purposes to Objective 2. Finally, if changes in measured cost avoidances necessarily must be transmitted to discounts, matters of costing methodology may become even more controversial than they have been, since any such changes (particularly for workshare cost avoidance models) would have direct pricing implications.[457]

VII. CONCLUSION

The price cap has failed to achieve most or all of the statutory objectives. Moreover, it is unnecessary in light of the adequacy of market pressures to incentivize efficiency, service quality, and pricing restraint. Therefore, the Commission should replace it with a new system that will achieve the statutory objectives, based on regulatory monitoring and forward guidance.

[457] Requiring the Postal Service to justify passthroughs that are less than 100 percent of avoided costs, in a manner similar to what occurs today for passthroughs above 100 percent of avoided costs, would also increase the administrative burden of the ratemaking process.